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No. 563

In the

Supreme Court of the United States

OCTOBER TERM, 1967

SIMON W. HENDERSON, JR.,
Independent Executor for the Estate of
LOUISE R. HENDERSON, Deceased,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

Simon W. Henderson, Jr., Independent Executor for the Estate of Louise R. Henderson, Deceased, Petitioner, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit (hereinafter referred to as the Fifth Circuit) entered in the above entitled case on March 23, 1967.

CITATIONS TO OPINIONS BELOW

The opinion of the United States District Court, Eastern District of Texas, Tyler Division, printed in Appendix B hereto, infra p. B-1 is reported in 232 F. Supp. 1.

The opinion of the Fifth Circuit printed in Appendix B hereto, infra p. B-18, is reported in 275 F. 2d 36.

The opinion of the District Court in *Frederick Henderson and Louise Henderson v. United States of America* printed in Appendix C hereto, infra p. C-1 is reported in 245 F. Supp. 782.

JURISDICTION

The judgment of the Fifth Circuit was entered on March 23, 1967, (R. 1103), Appendix B, infra p. B-30. Petition for Rehearing En Banc was filed on April 25, 1967. (R. 1105). Petition for Rehearing was denied on June 13, 1967, (R. 1157), Appendix B, infra p. B-32. Petition for Rehearing En Banc was denied on July 12, 1967, (R. 1162), Appendix B, infra p. B-33. The jurisdiction of this Court is invoked under 28 U.S.C.A. Sec. 1254(1).

QUESTION PRESENTED

The question for decision in this case is whether certain advances by petitioner totalling $455,000.00 to MacKay Foundry, Inc., a Texas corporation, during the period involved, are deductible pursuant to Section 166(a) of the Internal Revenue Code of 1954 as business bad debts in the year 1957. The District Court determined that the advances to MacKay and the stock of MacKay became worthless in 1957 and respondent did not appeal these issues from the District Court. The District Court further determined that the investment of petitioner in stock of MacKay was a capital loss and respondent did not appeal this issue.

STATUTES INVOLVED

The statutory provisions involved are Section 166(a) and Section 166(d) of the Internal Revenue Code of 1954, 26 U.S.C.A., 659 (I.R.C. 1954). They are printed in Appendix A, infra p. A-1. Section 1.166-1(a) of the Income Tax Regulations, 26 C.F.R. 363, 364, and Section 1.166-5(a) and (b) of the Income Tax Regulations, 26 C.F.R. 366, 367, are printed in Appendix A, infra p. A-2.

STATEMENT

The case originated in the District Court on a complaint filed by Louise R. Henderson for refund of income taxes and interest in the amount of $300,144.99 for the taxable years 1953 through 1959. (R. 2-11). Louise R. Henderson died prior to trial and Simon W. Henderson, Jr., her Independent Executor, was substituted as plaintiff and is petitioner herein. The complaint was filed pursuant to Judicial Code, as amended, 28 U.S.C.A. Section 1346(a)(1) and Section 1402(a). (R. 2). The District Court held that the petitioner was entitled to deduct in the year 1957 the $455,000.00 of advances to MacKay as a business bad debt pursuant to Section 166(a) of the Internal Revenue Code of 1954, since it determined that the advances by the petitioner to MacKay were loans and that these loans were made in connection with and proximately related to her trade or business of lending money. (R. 75, 76). The Fifth Circuit reversed the decision of the District Court and rendered a judgment in favor of respondent. (R. 1103). Appendix B,

infra p. B-30. The years 1955 and 1956 and the years 1958 and 1959 are involved because the loss in 1957 resulted in a carryback and carryforward loss. (R. 27, 28).

The advances in dispute were made by petitioner to MacKay under the following facts and circumstances:

On November 7, 1927, Louise R. Henderson gave her son, Simon W. Henderson, Jr., a power of attorney to represent her in all matters relating to her estate, which power of attorney he exercised from that date until her death, December 5, 1963. (R. 265, 266).

MacKay was incorporated under the laws of Texas on February 12, 1953, and stock in the total amount of $30,000.00 was issued to the following individuals:

	Shares
Louise Henderson	70
Malcolm G. Alexander	70
R. J. Reynolds	100
W. D. Culwell	40
S. W. Henderson, Jr.	10
V. G. Koch	10
	300

Each share had a par value of $100.00. All stockholders paid cash for their stock except R. J. Reynolds, who received his 100 shares in exchange for the contribution of an existing foundry called MacKay Foundry Company, a small foundry owned and operated by him prior to the

date of incorporation. A value of $10,000.00 was placed on this existing foundry and its equipment. (R. 31, 32).

When MacKay was originally organized it was decided that Reynolds would take care of the foundry and production end of the business; that Culwell would handle sales and that Alexander would maintain the office and the books. (R. 33).

The MacKay stock ownership set out above remained the same until October 1953, when Reynolds had a falling out with Culwell and Alexander, and Reynolds sold his 100 shares of MacKay to petitioner for $7,500.00. (R. 39).

Between April 14, 1953, and July 14, 1953, MacKay obtained four loans from the Lufkin National Bank of Lufkin, Texas, totalling $60,000.00, at 4% interest, evidenced by four notes, each of which was endorsed by petitioner's son under his power of attorney from petitioner. (R. 36). Petitioner, acting through her son, made two advances to MacKay totalling $55,000.00 in July 1953 at 4% interest. These advances were evidenced by notes. (R. 37). Up until October 13, 1953, when Reynolds resigned and sold his stock, petitioner loaned MacKay an additional $12,000.00 at 4% interest evidenced by a promissory note. (R. 37, 38).

Thus, from February to October 1953, when unrelated parties owned fifty percent of the stock of MacKay, petitioner guaranteed $60,000.00 of bank loans to MacKay and made direct loans of $67,000.00 at 4% interest evidenced by promissory notes, which loans the Fifth Circuit held to be

capital contributions to MacKay. At no time were petitioner's advances to MacKay proportionate to stockholdings and during the first nine months of MacKay's existence, when Reynolds was a stockholder, the advances were substantially disproportionate to stockholdings. During the remainder of 1953, petitioner made additional advances to MacKay of $12,000.00. (R. 37, 38).

Although a great effort was made to make MacKay a profitable foundry operation it continued to lose money (R. 771-813) and in March of 1957, the operation of MacKay ceased. (R. 40). Prior thereto petitioner continued to advance money to MacKay: $94,000.00 in 1954, $137,000.00 in 1955 and $145,000.00 in 1956. (R. 37, 38, 39). It is the deductibility of all of these advances to MacKay which is in issue in this case.

Petitioner and her son were never officers of MacKay and from February to October of 1953, they had a minority representation on the Board of Directors, and thereafter only had fifty percent representation on the Board. (R. 33, 34).

Each advance to MacKay was made by a check and when the checks were given to MacKay, the stub of each check, with one exception, showed the advances to be loans. (R. 37, 38). Petitioner's son testified that this one exception was also a loan. (R. 280, 281). Petitioner made 32 advances to MacKay, totalling $455,000.00 during the years 1953-1956, and the word "loan" was placed on the petitioner's check stubs approximately 31 times. Each loan to MacKay was

evidenced by a separately prepared and executed promissory note bearing 4% interest. (R. 38, 39). Each note was an unconditional promise to pay a sum certain at a fixed maturity date, and was payable in any event without condition, restriction or subordination.

Culwell, an unrelated stockholder and officer of MacKay, testified that the advances in question were borrowed by him and Alexander as corporate officers of MacKay on a businesslike basis as though they were borrowing money from a bank, and that they were unconditional loans which MacKay intended to repay. (R. 201, 207, 999, 1001, 1004, 1006, 1007, 1008, 1010, 1016).

Each such loan was set up when made on petitioner's books in a notes receivable ledger, and each such loan when made was set up on the books of MacKay in a notes payable ledger. (R. 39). The advances to MacKay were treated as loans on the many financial statements which were prepared by MacKay from time to time during its existence. (Stip. Ex. GG; R. 35, 36). These advances were treated as loans in the balance sheet of each income tax return filed by MacKay for the years 1953 to 1957. (Exhibits AA through FF, Stip. I).

Although Alexander and S. W. Henderson, Jr., were related to petitioner, Reynolds, Koch and Culwell were not related by blood or marriage to petitioner (R. 33) and owned fifty percent of the stock of MacKay until October 1953, when Reynolds resigned as President and sold his

100 shares of stock in MacKay to petitioner for $7,500.00. (R. 39, 40).

MacKay was formed because it was believed that there was a demand for gray iron castings in the State of Texas and that these castings could be profitably produced by MacKay capitalized at $30,000.00 and with additional loans to be obtained from a bank of approximately $60,000.00. (R. 486-492).

MacKay did not own its own land and building in which its operations were conducted, but leased certain premises for such business from an unrelated party. (R. 40).

All of the stockholders of MacKay, including Koch and Culwell, except petitioner and R. J. Reynolds (both of whom did not testify), testified unequivocally that the advances made by petitioner to MacKay were unconditional loans which MacKay intended to repay and that there were no conditions attached to these loans. (Henderson R. 276, 286, 343, 351, 357, 497, 619, 622; Alexander R. 788, 789, 790, 796, 821, 822, 829; Culwell R. 201, 207, 999, 1001, 1004, 1006, 1007, 1008, 1010, 1016; Koch R. 177, 938, 939). The credibility of these witnesses was not impeached and their testimony was corroborated by the documentary evidence discussed above and is not inherently improbable.

Considerable evidence was introduced by petitioner in the District Court which proved that petitioner was in the lending business during the years 1924 through 1959, including

the years 1953 through 1957, the period involved. (R. 41-47; Pl. Ex. 17). The proof was extensive and was believed by the District Court Judge who held that petitioner was in the lending business. (R. 75).

At the time of petitioner's husband's death in 1923, he had total notes receivable outstanding in excess of $100,000.00. (R. 41, 42, 615). From 1924 through 1959, petitioner, through her son, made a total of 330 loans to individuals, corporations and businesses totalling approximately $1,563,039.00. During this period there were a total of 810 principal repayments of these loans aggregating $978,825.02 and a total of 413 interest collections on these loans totalling $99,620.67, making a total of 1,553 transactions (loans made and principal and interest repayments) during these years. (See Pl. Ex. 17). The details of these loan transactions are discussed hereinafter under Part "C", infra p. 24.

Extensive records of such lending business were maintained (R. 62; Exs. B-2 through B-11 to Supp. Stip. No. 2); an office was maintained from which the lending business was conducted, together with other business affairs of petitioner (R. 273); petitioner's employees, including her son, spent a considerable amount of time on the money lending activities (R. 273); and four witnesses, including the President and an Assistant Cashier of the Lufkin National Bank testified that petitioner had a reputation in the community for being in the lending business. (R. 239, 249, 433, 456).

Substantial lending activity took place during the years 1953-1957 (the period involved) in addition to the 32 loans

which were made to MacKay. Substantial amounts of principal and interest were collected during the period. (Pl. Ex. 17).

The uncontradicted evidence overwhelmingly showed that petitioner was in the lending business, and that the advances to MacKay were loans made in the course of that lending business and were intended to be repaid at a profit; namely, interest, and the loans were not made primarily to assist petitioner's grandson-in-law as the Fifth Circuit erroneously concluded.

The District Court held that petitioner's advances to MacKay were loans and that petitioner was in the business of lending money during the years 1953 to 1959, and for many years prior thereto, and that petitioner's loans to MacKay were proximately related to her business of lending money.

The Fifth Circuit held that petitioner's advances to MacKay were not loans but were capital contributions; that petitioner was not in the lending business during the period involved; that the loans to MacKay were not proximately related to her business of lending money.

SUMMARY OF REASONS FOR GRANTING THE PETITION FOR WRIT OF CERTIORARI

A. The District Court Judge who sat on the panel of Judges who heard this case on appeal was disqualified. (Section 47, Title 28 U.S.C.A.)

B. The decision of the Fifth Circuit is in conflict with decisions of other circuits.

C. The Fifth Circuit did not apply the "unless clearly erroneous" rule. (Rule 52(a), Federal Rules of Civil Procedure)

D. The decision of the Fifth Circuit is in conflict with decisions of this Court.

E. Statutes authorizing District Court Judges to sit on Courts of Appeal are unconstitutional.

REASONS FOR GRANTING THE PETITION FOR WRIT OF CERTIORARI

A. Disqualification of District Court Judge on Panel

District Court Judge Johnson, who wrote the opinion of the Fifth Circuit in the instant case, was disqualified from participating in the decision of this case because he, as a District Court Judge, had decided the identical issue involved in the instant case in favor of the respondent on July 19, 1965, in *Frederick Henderson and Louise Henderson v. United States of America*, 245 F. Supp. 782, and that case was on appeal to the Fifth Circuit at the time the instant case was argued before the Fifth Circuit on October 11, 1966. *Frederick Henderson, supra*, was argued before a panel of the Fifth Circuit in Montgomery, Alabama, on October 27, 1966. (R. Vol. VI). Therefore, at the time the instant case was argued and decided, Judge Johnson had a conflict of interest because of the pending appeal of a case he had

decided as a District Court Judge. How could petitioner have hoped for a favorable vote from Judge Johnson on an issue which he had decided in favor of respondent in a case which was on appeal to the Fifth Circuit at the time of argument and in which case respondent made the same contentions as were made in the instant case? The inequity of the situation would be even more apparent if the District Court Judge who had decided the instant case had been allowed to sit as a judge when this case was appealed to the Fifth Circuit. There is no essential difference in the two situations. Judge Johnson was as interested in having his decision in the case of *Frederick Henderson, supra,* upheld indirectly as he would have been if he sat on the panel which heard that case on appeal.

At the time counsel for petitioner argued the instant case they did not know of the existence of the *Frederick Henderson* case, or that it was on appeal to the Fifth Circuit. Petitioner's counsel did not know that District Court Judge Johnson was going to sit on the panel which heard and decided the instant case until the day before the case was argued on October 11, 1966, after petitioner's counsel had arrived in New Orleans, Louisiana.

Permitting Judge Johnson to sit on the panel which decited the instant case was contrary to Section 47 of Title 28 U.S.C.A. which provides:

> "No judge shall hear or determine an appeal from the decision of a case or *issue* tried by him." (Emphasis supplied)

In *Moran v. Dillingham*, 174 U.S. 153, this Court expressed itself as to the purpose of this section as then written. This Court stated:

> "The intention of Congress, in enacting that no judge before whom 'a cause or question may have been tried or heard,' in a district or circuit court, 'shall sit on the trial or hearing of such cause or question' in the circuit court of appeals, manifestly was to require that court to be constituted of judges uncommitted and uninfluenced by having expressed or formed an opinion in the court of first instance."

Judge Johnson had decided the same issue or question in *Frederick Henderson* as a District Court Judge as was before him when he sat on the panel of Judges in the Fifth Circuit in the instant case. He, therefore, contrary to Section 47, Title 28 U.S.C.A., heard or determined while sitting as a Judge on the Fifth Circuit in this case an *issue* or question tried by him as a District Court Judge, which issue or question was on appeal to the Fifth Circuit at the time the instant case was argued.

Judge Johnson sitting as a Fifth Circuit Judge in the instant case was committed and influenced by having expressed or formed an opinion on the issue or question since he had decided the *Frederick Henderson* case as a District Court Judge and that case was on appeal to the Fifth Circuit when he sat as one of the panel of Fifth Circuit Judges.

It is submitted that Section 47 prohibits a District Court Judge from hearing and determining as an Appellate Court Judge the same issue as in involved in a case decided by

him as a District Court Judge and which decision is pending on appeal to the same Appellate Court at such time.

That Section 47 prohibits what was done here is supported by Judge Brown's opinion in *Chance v. United States*, 331 F. 2d 473 (5th Cir., 1964), wherein Judge Brown stated:

> "It is obvious that Judge Whitehurst did not, as a trial judge, decide this case nor try any issue relating to it. He had not previously 'expressed or formed an opinion in the court of first instance.' Moran v. Dillingham, 174 U.S. 153, 157; 19 S. Ct. 620, 622; 43 L. Ed. 930. The issue had never been raised in cases tried by him (assuming that it be material that he had presided at the trial of other defendants indicted by the grand juries in question), and he had nothing to do with the proceeding in this case before it was appealed. He had made no prior ruling on the question presented here in this case or in any other case."

The clear implication of the *Chance* decision is that the word "issue" used in Section 47 may be an issue decided by a District Court Judge in another case. It should be further noted that Section 47 refers to "case" *or* "issue."

In *Frederick Henderson*, Judge Johnson held that advances to a corporation by its stockholders were contributions to capital rather than loans, the same issue involved in the instant case. Upon a former trial, the factual issues were submitted to a jury upon special written interrogatories and the jury answered these interrogatories favorably to the taxpayer; namely, that the advances were loans. On motion of the Government, Judge Johnson granted a new trial and on

the basis of the transcript of the proceedings of the former jury trial, he held against the taxpayer in favor of the respondent and determined that the advances were capital contributions.

In so holding, Judge Johnson stated:

> "Upon consideration of the evidence, this Court now specifically finds and concludes that the taxpayer, Frederick Henderson, and the other shareholders intended to take the risk incident to a capital investment when they made the various advances to the corporation."

His support for the legal assumption underlying this conclusion is given by Judge Johnson as follows:

> "The United States Court of Appeals for the Sixth Circuit in *United States v. Title Guarantee & Trust Co.*, 133 F. 2d 990, in considering the distinction between a stockholder and a creditor, stated:
>
> > "'*The essential difference between a stockholder and a creditor is that the stockholder's intention is to embark upon the corporate adventure, taking the risks of loss attendant upon it, so that he may enjoy the chances of profit.* The creditor, on the other hand, does not intend to take such risks so far as they may be avoided but merely to lend his capital to others who do intend to take them.' (Emphasis in original.)"

Judge McAllister of the Sixth Circuit wrote the opinion which included this language in 1943. In 1960 in *Byerlite Corp. v. Williams*, 286 F. 2d 285 (6th Cir., 1960), Judge McAllister repudiated the above language of *United States v.*

Title Guarantee & Trust Co., 133 F. 2d 990 (6th Cir., 1943), as follows:

> "In its claim that the debts as shown on the books of Byerlite and Export were, in reality, payments from Byerlite to Export for the latter's stock, the government cites United States v. Title Guarantee & Trust Co., 133 F. 2d 990, 993 (C.C.A. 6):
>
> > "'*The essential difference between a stockholder and a creditor is that the stockholders' intention is to embark upon the corporate adventure, taking the risks of loss attendant upon it, so that he may enjoy the chances of profit.* The creditor, on the other hand, does not intend to take such risks so far as they may be avoided, but merely to lend his capital to others who do intend to take them.'
>
> "In its comment on the above, the government says: 'In other words, the stockholder intends to make an investment and take the risks of the venture, while the creditor seeks a definite obligation, payable in any event.'
>
> "But it does not help the solution of the problem to speak of the man who invests in stock of a corporation as the one who takes the risks and the creditor as the one who seeks a definite obligation, payable in any event. One who makes a loan to a corporation also takes a risk, and while he may receive evidence of an obligation, payable in any event, often such obligation is never paid. To say that the advances were "gambled" and placed at the risk of the business does not help * * * All unsecured loans involve more or less risk. On all available information, the risk was a good one. And it cannot be said, in contravention of the testimony at the trial, that the holders * * * had no reasonable expectations that they would be repaid.' Earle v. W. J. Jones & Son, Inc., 200 F. 2d 846, 851 (C.A. 9)."

No mention of such repudiation is made in Judge Johnson's opinion. In other words, Judge Johnson based his opinion on a so-called "risk of the business" theory based

on precedent which was repudiated by the judge who wrote the opinion, and no mention of this is made in his opinion.

Judge Johnson also decided in the *Frederick Henderson* case that the advances which he held to be contributions to capital constituted a second class of stock and, therefore, the stockholders' election under Subchapter S was not valid. Judge Johnson's conclusion on this point was later held to be erroneous by the Government itself and the taxpayer received a 100% refund in spite of Judge Johnson's opinion in the *Frederick Henderson case.* (R. Vol. VI).

Judge Johnson evidently had his opinion in *Frederick Henderson* before him when he wrote the opinion in the instant case because identical erroneous reasoning is employed in the instant case, as he employed in the *Frederick Henderson* case when writing the opinion as a District Judge and identical cases are relied upon. Evidently the instant case was decided on the basis of the record in the *Frederick Henderson* case and not on the basis of the record in the instant case because the findings of fact in the instant case followed closely the findings of fact made by Judge Johnson in the *Frederick Henderson* case when these findings have no suport in the record in the instant case.

It is submitted that since Judge Johnson was disqualified from hearing and determining the instant case, the case should be reversed and rendered in favor of petitioner, or, alternatively, reversed and remanded to the Fifth Circuit to be heard and determined by three impartial, qualified Judges.

B. The Decision of the Fifth Circuit Is in Conflict With Decisions of Other Circuits

1. *Loan Versus Capital Contribution Issue*

The Fifth Circuit held that petitioner's loans to MacKay were capital contributions and this holding is in conflict with *Wilshire & Western Sandwiches, Inc. v. Commissioner*, 175 F. 2d 718 (9th Cir., 1949); *Earle v. W. J. Jones & Son, Inc.*, 200 F. 2d 846 (9th Cir., 1952); *Estate of Herbert B. Miller v. Commissioner*, 239 F. 2d 729 (9th Cir., 1956); *Lundgren v. Commissioner*, 376 F. 2d 623 (9th Cir., 1967); *Byerlite Corp. v. Williams, supra.*

Upon facts substantially the same as those of the instant case the Ninth Circuit in the case of *Wilshire & Western Sandwiches, Inc., supra*, held the advances made in that case to be loans because it found that the transaction was bona fide; namely, that there was an intention to create an indebtedness. There is no question but what the petitioner in the instant case intended the advances to MacKay to be loans. Even the respondent on brief and oral argument in the Fifth Circuit admitted that "all of the participants in MacKay recognized that the corporation would repay the advances in the event it was successful * * *" (Respondent's brief, p. 28).

In *W. J. Jones & Son, Inc., supra*, the ratio of debt to equity was 6-1, and the noteholders did not attempt to collect the principal or interest on the notes when due, and the notes were subordinated to other accounts. The Ninth Circuit in holding for the taxpayer relied heavily on the fact

that the advances involved were not in direct proportion to stock ownership. The disproportion of loans to stock ownership in the instant case, as well as the unimpeached testimony of unrelated parties that the advances were loans, was completely and erroneously disregarded by the Fifth Circuit. In view of the fact that when petitioner was only a 23% stockholder (and no more than 50% counting her relatives) she made substantial advances and guarantees during the period February 1953, to October 1953, proves, as a matter of law, that the advances were loans. If petitioner had stopped making advances when Reynolds resigned, is it not clear that a debt existed?

In *Estate of Herbert B. Miller, supra*, the Ninth Circuit held contrary to the Fifth Circuit in the instant case that the mere fact that the corporation there involved intended to pay advances out of future earnings, did not negate the character of the instruments. Furthermore, the Ninth Circuit in the *Miller* case stated:

> "We know of no rule which permits the Commissioner to designate what portion of a corporation's operations shall be provided for by equity financing rather than debt."

The Fifth Circuit erroneously applied a ratio test to petitioner in determining that her advances to MacKay were capital contributions and not loans.

In the *Lundgren* case *supra* the notes involved were subordinated to a loan from the Small Business Corporation and bore 4% interest, the same interest rate as the notes in the instant case. The Ninth Circuit in holding for the taxpayer stressed the fact that all the documents of the transaction

indicated that the parties intended the transaction to create conventional debts and that the advances were debts. This case clearly is in conflict with the decision of the Fifth Circuit in the instant case on this issue.

In *Byerlite Corp., supra*, the Sixth Circuit held certain advances to be loans and not capital contributions, even though the advancements were made without requiring any evidence of indebtedness or fixing any date for repayment and without requiring the payment of any interest and even though the tangible assets of the corporation were not sufficient to repay any part of the loan during the taxable period. In so holding, the Sixth Circuit stressed the fact that the nomenclature involving the advances was that of debt and that it was not used to disguise something different and the transaction was not a sham. Similarly, all of the evidence in the instant case discloses that the transaction was not a sham.

2. ***Lending Business Issue***

In *Commissioner v. Smith*, 203 F. 2d 310 (2nd Cir., 1953), the Second Circuit stated:

> "Of course if respondent were regularly engaged in lending money to business enterprises, bad debt losses resulting therefrom would be incurred in his business."

Petitioner in the instant case abundantly proved that a lending business was regularly carried on by her yet the Fifth Circuit refused to hold that she was in the lending business, and its decision is contrary to the *Smith* case.

The Fifth Circuit erroneously held that activities must occupy a *substantial* amount of taxpayer's time in order to constitute a trade or business. Although it is submitted that

petitioner's lending activities were substantial in the instant case, nevertheless the Fifth Circuit's definition of trade or business in this matter conflicts with a long line of decisions which hold that the mere ownership of rental real property creates a trade or business. Thus, in *Reiner u. United States*, 222 F. 2d 770 (7th Cir., 1955), a taxpayer who conducted no management activities with respect to her single piece of rental property was held to be engaged in a trade or business. This same principle was recognized by this Court in *Whipple v. Commissioner*, 373 U.S. 193. The decision of the Fifth Circuit in the instant case conflicts with these cases.

Furthermore, the decision of the Fifth Circuit is in conflict with other Circuit Court decisions defining a trade or business for purposes of determining whether a taxpayer has held property for sale to customers in the ordinary course of a trade or business under Section 1221 of the Internal Revenue Code. See *Commissioner v. Boeing*, 106 F. 2d 305 (9th Cir., 1939), cert. den. 308 U.S. 619 (1939); *Palos Verdes Corp. v. United States*, 201 F. 2d 256 (9th Cir., 1952), and *Shearer v. Smyth*, 221 F. 2d 478 (9th Cir., 1955), aff'g. per curiam opinion of District Court 116 F. Supp. 230 (N.D. Calif., 1953). These cases make it clear that in determining whether real estate is held for sale to customers in the course of a business continuity of sales and sales related activities over an extended period of time must be considered. If each loan made in the instant case from 1924 to 1959 had

been a sale of real estate there is no question but what petitioner would have been in the real estate business if that were in issue.

The definition of the Fifth Circuit of the word "business" is also erroneous because it does not take into consideration petitioner's substantial lending activities before and after the period involved; substantial collection activities of principal and interest during the period and the fact that 32 separate loans, totalling $455,000.00 were made to MacKay during the period, and the fact that the making of the loans to MacKay consumed a substantial portion of petitioner's lendable funds during the period. Under the circumstances of this case the loans to MacKay should have been taken into account in determining whether petitioner was engaged in the lending business. If the question involved was whether petitioner was in the real estate business, the sales in issue would certainly be taken into account in making the determination.

3. *Proximately Related*

The Fifth Circuit erroneously held that petitioner's loans to MacKay were not proximately related to her lending business, and this determination is in conflict with *Weddle v. Commissioner*, 325 F. 2d 849 (2nd Cir., 1963). The main reason relied on by the Fifth Circuit in so holding was that the loans were made to help petitioner's grandson-in-law, Alexander. This holding is not supported by the record, but

even if true it would not be determinative under the principles announced in the *Weddle* case. In that case the Second Circuit stated:

> "In the law of torts, where the notion of 'proximate' causation is most frequently encountered, a cause contributing to a harm may be found 'proximate' despite the fact that it might have been 'secondary' to another contributing cause. See 2 Harper & James, The Law of Torts. §§20.2 and 20.3; American Law Institute, Restatement, Torts, §§432(2), 433, 439, 875, 879 (1939); Restatement Second, Torts, §443A at 54 (Tent. Draft No. 7, 1962), §442B at 29 (Tent. Draft No. 9, 1963). So here, particularly in view of the backhanded wording of §166, it suffices for deduction that the creation of the debt should have been significantly motivated by the taxpayer's trade or business, even though there was a non-qualifying motivation as well."

Even if one of petitioner's motives in making the loans to MacKay was to help her granson-in-law, a significant motive was to have her money repaid at interest and, therefore, under the *Weddle* doctrine, the loans were proximately related to her lending business. There is no evidence in the record that her son, acting as her agent, intended to, or was authorized to make a gift of $455,000.00 to MacKay, or to her grandson-in-law. The record is replete with testimony to the contrary.

The conflicts set out above are matters of principle and of law but if it is held that the decision in the instant case does not conflict with the decisions in the other Circuits because the issues are factual, then as clearly shown in Part "C" hereof (infra p. 24) the decision of the Fifth Circuit is contrary to the "unless clearly erroneous" rule.

C. Error of Fifth Circuit in Failing to Apply the "Unless Clearly Erroneous" Rule

The Fifth Circuit has radically departed from the accepted and usual course of judicial proceedings in the instant case since in reaching its decision it did not apply the "unless clearly erroneous" rule provided by Rule 52(a) of the Federal Rules of Civil Procedure. The question is a factual one in each particular case arising under Section 166 of the Internal Revenue Code of 1954. *Higgins v. Commissioner*, 312 U.S. 212; *Whipple v. Commissioner, supra.* The question of intent if at all doubtful, either because of a conflict in the evidence, or because different inferences normally may be drawn, is a question of fact for the trial court and only becomes a question of law for a reviewing court if the evidence is all one way or so overwhelmingly one way as to leave no doubt as to the facts: See *Boehm v. Commissioner*, 326 U.S. 287; *Commissioner v. Duberstein*, 363 U.S. 278; *Crown Iron Works Co. v. Commissioner*, 245 F. 2d 357 (8th Cir., 1957). The Fifth Circuit failed to apply these standards in its decision of the instant case. The evidence in the District Court was not so overwhelmingly against petitioner as to leave no doubt as to the facts. Indeed, the evidence overwhelmingly favored petitioner.

By absolutely refusing to give any weight to the facts in the record of this case sustaining the judgment of the District Court and making inferences of facts not justified by the record, the result has been that the Fifth Circuit totally

ignored the "unless clearly erroneous" rule which under the facts and circumstances of this case required that the judgment of the District Court be affirmed. The following material facts relied upon by the Fifth Circuit to sustain its judgment were either erroneous inferences from the record or were misstatements of fact brought about by a misinterpretation of the facts in the record or were a reliance on facts having no legal significance:

1. *Loan Versus Capital Contribution Issue*

The Fifth Circuit erred in the instant case in holding that petitioner's advances to MacKay were capital contributions rather than loans. The Fifth Circuit's decision on this issue was based on the following:

(a) Advances were continued even though the business kept losing money.

(b) No part of the interest or principal was ever repaid.

(c) Advances were subordinated to claims of other creditors of the business.

(d) It was generally understood that repayment of advances was contingent on the success of the business, and was to be made only out of profits.

(e) MacKay was thinly capitalized.

Reasons (a) and (b) are not germane to the issue since these factors are usually present in all bad debt cases and are not conclusive. The problem invariably begins at this

point. Reasons (c) and (d) establish incorrect legal principles based on the record and if they do not they have no support in the record.

The advances to MacKay were not subordinated to the claims of other creditors of the business in any manner having legal significance. The only creditors of MacKay other than petitioner were suppliers of material and labor. In order to continue operations (which admittedly were not profitable) tradesmen and workers had to be paid (R. 363), and funds were advanced for this purpose. This was done with the expectation that the operations would ultimately be a success and all loans repaid at interest. This is precisely where the bad debt problem begins. There was no subordination to the loans of *other corporate lenders.* In a case decided subsequent to the instant case the Fifth Circuit has held that even the fact of subordination to loans of other lenders is not conclusive. See *Laurie W. Tomlinson v. The 1661 Corporation,* 377 F. 2d 291 (5th Cir., Aug. 7, 1967), wherein although there was an express subordination of the loans involved to other loans the Fifth Circuit held that the advances were loans.

The Fifth Circuit erred in holding that it was generally understood that repayment of advances was contingent on the success of the business and that repayment was to be made only out of profits. This proposition has legal significance only if it means that there was some legal restriction on repayment where, for example, the debt instrument itself relates payment to net profits. See *The Kelly Company v. Commissioner,* 326 U.S. 521. A reading of the record in the

instant case clearly proves that there was no such limitation. The Fifth Circuit took testimony of petitioner's son which disclosed that the *fact of repayment* was dependent upon MacKay's success to support the erroneous conclusion that the *right of repayment* was dependent on the success of MacKay. (R. 344, 345). The record of the case amply shows that there was no way that petitioner's loans could be repaid as a practical matter unless MacKay was a success and this was the substance of petitioner's son's testimony. There is nothing in this record to show that these promissory notes were to be paid only out of future earnings. If petitioner had brought suit, secured a judgment and execution had issued, any property owned by the corporation could have been sold to satisfy the judgment, thus cutting off all unsecured creditors. Even if promissory notes are by their terms to be paid out of future earnings, this does not vitiate their validity. *Estate of Herbert B. Miller v. Commissioner, supra.* To require a loan to be repaid from sources other than the earnings of the borrower is at odds with commercial practice and the common understanding of what constitutes a loan. This Court rejected a similar contention as to the meaning of the word "sale" in *Commissioner v. Brown*, 380 U.S. 563.

This principle is also contrary to I Dewing "The Financial Policy of Corporations" (Fifth Edition) wherein it is stated at page 214:

> "* * *—there are many types of bonds which rest on the general credit of the corporation. * * * Bonds issued on the general credit rest, as nearly all other corporate securities ultimately rest, on the earning capacity of the corporation. * * *"

See also Graham, Dodd and Cottle's "Security Analysis Principles and Technique" (Fourth Edition), pages 310 and 311, where the point is made that the safety of a bond as an investment should be measured not by lien security but by ability to pay. The decision of the Fifth Circuit in the instant case departs from current commercial theory and practice and resorts to anachronistic pre-depression principles as to the meaning of the word "debt."

The Fifth Circuit further erred in holding that (1) the debt to equity ratio was high to start with, and (2) the parties understood it would likely go higher. There is no support in the record for these conclusions. The record clearly shows that the initial capitalization was not thin, nor was it intended to be thin. All of the testimony discloses that it was believed that MacKay could achieve the level of production desired with $30,000.00 of capital and $60,000.00 of loans. (R. 194, 283, 489-491). The ratio of debt to equity of 15-1, which ultimately resulted more by accident than design, was no higher than the ratio in *Rowan v. United States*, 219 F. 2d 51 (5th Cir., 1955), *Giblin v. Commissioner*, 227 F. 2d 692 (5th Cir., 1955), and many other cases. Even in the decision of the Fifth Circuit in the subsequently decided *The 1661 Corporation* case, *supra*, the ratio was 14.6-1 but the Fifth Circuit nevertheless held the advances to be loans.

There is no authority for the proposition that stockholders of a corporation may not determine just how much of their funds they care to risk in the form of capital and how much, if any, they are willing to lend as credit. Congress has not

by statute provided any ratio and it is not within the province of courts to prescribe a ratio as did the Fifth Circuit in the instant case.

Thus, the conclusion of the Fifth Circuit on this issue is based on factors having no legal significance and if allowed to stand establishes the following erroneous proposition: *Unsecured advances on which no interest or principal are repaid and which are made to pay materialmen and laborers to keep a business going and which as a practical matter can be paid only out of earnings are capital contributions rather than loans.* The mere statement of the proposition reveals its absolute unsoundness and the Fifth Circuit should be reversed on this issue and the holding of the District Court affirmed as not being clearly erroneous.

2. *Lending Business Issue*

The Fifth Circuit erroneously concluded that petitioner was not in a continuous course of conduct of making loans, the purpose of which was the derivation of profits. This conclusion of the Fifth Circuit is contrary to the record in this case, which overwhelmingly discloses that petitioner was involved in a continuous course of making such loans from 1924 through 1959 from which profit was derived and the District Court found this to be a fact and its determination on this issue is supported by the record and is not clearly erroneous. The following summary of loans and collections

made by petitioner from 1924 through 1959 (including loans to MacKay) clearly proves that petitioner was in the lending business:

Summary of Loans made by Petitioner from 1924 through 1959 (including loans to MacKay)

	Loans Made		*Repayments*		*Interest Collected*		*Total No. of Transactions*
Year	*Number*	*Amount*	*Number*	*Amount*	*Number*	*Amount*	
1924	1	$ 10,000.00			1	$ 350.00	2
1925	3	20,200.00			6	1,600.00	9
1926	7	18,760.90	1	$ 10,000.00	2	700.00	10
1927	18	38,825.58	1	10,000.00	8	755.00	27
1928	21	32,730.00	4	10,265.58	11	2,717.30	36
1929	21	55,728.35	13	29,400.94	13	2,960.38	47
1930	21	15,170.68	11	6,934.58	10	3,891.96	42
1931	15	6,975.22	5	22,200.00	10	3,376.66	30
1932	36	13,144.22	2	1,343.33	2	1,570.07	40
1933	19	547.00	3	155.00	17	377.55	39
1934	8	195.00	14	6,859.49	13	3,683.23	35
1935	7	1,852.48	31	5,372.84	8	147.00	46
1936	8	285.00	54	10,623.07	6	115.25	68
1937	3	975.00	29	22,603.13	5	4,406.65	37
1938	1	4,000.00	27	4,686.61	8	183.73	36
1939			41	5,947.65	12	262.35	53
1940	1	500.00	45	10,004.73	16	1,101.56	62
1941			55	19,216.04	25	4,583.84	80
1942	3	25,328.53	30	5,468.93	17	10,651.87	50
1943	4	2,450.00	20	25,420.36	6	1,959.31	30
1944	3	39,600.00	31	35,234.99	5	2,228.97	39
1945	8	33,905.00	32	16,821.00	23	4,046.02	63
1946	4	22,075.00	35	7,170.00	14	10,510.81	53
1947	17	70,905.00	37	20,045.16	19	2,257.24	73
1948	16	58,175.00	52	54,710.00	18	2,648.14	86
1949	11	91,172,77	39	19,989.59	24	3,195.10	74

Year	Loans Made		Repayments		Interest Collected		Total No. of Transactions
	Number	Amount	Number	Amount	Number	Amount	
1950	13	95,400.00	25	137,187.22	33	5,363.82	71
1951	5	21,101.00	34	89,882.77	27	2,733.15	66
1952	7	187,075.00	24	117,950.00	20	1,948.59	51
1953	7	110,357.27	22	59,000.00	18	5,561.83	47
1954	11	94,165.00	27	33,027.00	9	4,622.68	47
1955	7	138,550.00	24	80,141.27	4	1,282.04	35
1956	14	145,000.00	10	320.00	2	165.00	26
1957	6	27,425.00	8	1,274.37			14
1958	3	465.00	17	7,315.87			20
1959	1	180,000.00	7	92,253.50	1	7,663.57	9
Total	330	$1,563,039.00	810	$978,825.02	413	$99,620.67	1,553

(Pl. Ex. 17, R. 38, 39, 67, 68)

The list of loans made by petitioner from the year 1924 through 1959 (Pl. Ex. 26; R. 425) plus the list of the 32 loans to MacKay appearing on pages 38 and 39 of the record are impressive and, in summary, disclose that petitioner made a total of 330 loans from 1924 through 1959, totalling approximately $1,563,039.00; that there were a total of 810 principal repayments of these loans, aggregating $978,825.02 and a total of 413 interest collections on these loans totalling $99,620.67, making a total of 1,553 transactions (loans made and principal and interest repayments) during these years. These facts alone were sufficient to sustain the judgment of the District Court on this issue and were totally ignored by the Fifth Circuit.

Plaintiff's Exhibit 26 discloses that during the years 1953 through 1956 there were 83 repayments of principal on money petitioner had loaned in prior years and that these repayments of principal amounted to $172,488.27. From 1953 through 1956 there were 33 payments of interest amounting to $11,631.55, all of which were reported as ordinary income and tax paid thereon. From 1956 through 1959 there were 32 repayments of principal amounting to $100,843.74. Furthermore, the Fifth Circuit ignored the fact that from 1957 through 1959 petitioner made 10 loans totalling $207,890.00 and in 1959 there was one interest collection in the amount of $7,663.57. Summarizing these activities from 1953 through 1956, we find the following: 83 principal repayments, 33 interest payments and 7 loans, making a total number of loan transactions of 123 from 1953 through 1956 to compare with

the 7 loans which the Fifth Circuit held were the only loan activities for this period aside from the 32 MacKay loans. Counting the 32 MacKay loans, which were omitted from Plaintiff's Exhibit 26, there were a total of 155 loan transactions during the years 1953 through 1956. (Pl. Ex. 17; R. 38, 39, 67, 68). These loan activities, together with the other loans shown by the record in this case, must all be considered and were considered by the District Court, in determining whether the petitioner was in the lending business and whether the loans to MacKay were made in connection therewith. These facts were totally ignored by the Fifth Circuit.

The Fifth Circuit erroneously concluded that petitioner was not in the lending business because it concluded that aside from the loans to MacKay, there were only seven other loans made during the period and only one of these was interest-bearing. If there is any one legal principle well settled as to whether a particular taxpayer is engaged in a trade or business, it is that the activities must be gone into both prior to and subsequent to the tax years involved. The continuity and frequency of these transactions has been stressed in most of these cases. *Gamble v. Commissioner*, 242 F. 2d 586 (5th Cir., 1957); *Thompson v. Commissioner*, 322 F. 2d 122 (5th Cir., 1963).

Furthermore, the very loans in issue in this case; namely, 32 loans to MacKay totalling $455,000.00 made during the years 1953 to 1956 should have been taken into account in determining whether petitioner was in the lending business. The express refusal of the Fifth Circuit to do so in this case is clearly erroneous. The Fifth Circuit totally ignored

the fact that during 1953 to 1956 there were other lending activities such as 33 payments of interest totalling $11,631.55 and 83 repayments of principal totaling $172,488.27.

With regard to the 7 loans with respect to which it is alleged that only one was interest-bearing, we fail to find this fact from pages 42 to 47 of the record relied on in respondent's brief as support for this fact, yet the Fifth Circuit relied on this unsupported fact in its opinion. Furthermore, the record in this case discloses that every loan made by petitioner through her son was intended to be repaid with monetary interest, or interest in the form of services rendered. If petitioner was not involved in a continuous course of conduct of making loans, the purpose of which was a derivation of profits, no taxpayer will ever be able to prove this fact.

The Fifth Circuit obviously was led into error by the representation of the respondent who attempted to and did get the Fifth Circuit into the position of stating that the only evidence relied upon by the District Court to show a trade or business was the 32 loans to MacKay and 7 other loans, only one of which was interest-bearing. It thus appears that the respondent asked for a reversal of the District Court in the Fifth Circuit because the only evidence in the record on the question of the lending business "must depend on the very advances here in issue, i.e., those made to MacKay." It also asked for a reversal of the District Court because " the only lending activities of the taxpayer disclosed by the record were those of an investor in MacKay corporation and another business in which she owned an interest, plus a few noninterest-bearing personal loans." From

these statements of fact, one could think that during the entire time of petitioner's activity in the lending business only 32 loans were made to MacKay and only 7 other loans were made (during the years involved) and only one of these was interest-bearing. The entire opinion of the Fifth Circuit is based on this premise and nothing could be further from the fact and the law.

Furthermore, contrary to the opinion of the Fifth Circuit, petitioner's employees did devote a significant portion of their time to activities connected with the making of loans (R. 273); extensive records of such lending business were maintained (R. 62; Exs. B-2 through B-11 to Supp. Stip. No. 2); an office was maintained from which the lending business was conducted, together with other business affairs of petitioner (R. 273); and four witnesses, including the President and an Assistant Cashier of the Lufkin National Bank of Lufkin, Texas, testified that petitioner had a reputation in the community for being in the lending business. (R. 239, 249, 433, 456).

Respondent completely ignored facts which petitioner relied upon to show trade or business and the Fifth Circuit likewise completely ignored these facts. Thus respondent and the Fifth Circuit both failed to come to grips with the question in the case and its decision on this issue violates the "unless clearly erroneous" rule and should be reversed.

3. ***Proximately Related Issue***

The Fifth Circuit erroneously held that the purpose of the loans to MacKay was to help Malcolm Alexander, petitioner's grandson-in-law, get started in the foundry busi-

ness in Lufkin. The record does not sustain this conclusion and even if this was a purpose, it is of no legal significance since petitioner and all officers of MacKay intended for the advances to be loans and it was intended that they be repaid with interest. (R. 343, 351, 356, 357, 486, 520, 523, 524).

Here again, the Fifth Circuit assumed that Alexander was the only stockholder of MacKay other than petitioner and her son. Petitioner would also have been helping Reynolds, Koch and Culwell, who at first owned fifty percent of the stock until Reynolds sold his stock to petitioner in October of 1953.

Page 486 of the record was cited in respondent's brief for the proposition that these loans were made to help petitioner's grandson-in-law, Malcolm Alexander. This record reference does not support such a statement and neither is there any other evidence in the record to support such a statement.

Mr. Henderson testified that Alexander was merely a minority stockholder and, in fact, he owned 70 out of a total of 300 shares. He testified that Alexander was just another son-in-law; that he had four of them. (R. 523, 524). Alexander had only been a grandson-in-law for three years (R. 722) and had invested his own money in the company. Mr. Henderson further testified that his mother did not indicate she would make these loans because her grandson-in-law, Malcolm Alexander, was involved in this deal. (R. 493).

In view of the foregoing, we submit that the record is clear and unambiguous that petitioner did not make these loans with a view to helping her grandson-in-law get started in the foundry business in Lufkin and that such a statement is not only not sustained by the record but is in conflict therewith.

But, even if this were one of petitioner's motives in making the loans, it was not her only motive since there is no question but that it was intended that all these loans were to be repaid with interest and the record indisputably shows that she was in the lending business.

Since the record clearly establishes the fact that petitioner was in the lending business and these were loans, the fact that these loans may have indirectly benefited Malcolm Alexander, as well as unrelated parties, does not affect the principle that these loans were proximately related to her trade or business of lending money. See *Weddle v. Commissioner*, *supra*.

The District Court's determination of this issue was not clearly erroneous and should not have been reversed by the Fifth Circuit.

D. The Decision of the Fifth Circuit Is in Conflict With Decisions of This Court

1. The decision of the Fifth Circuit misapplies the doctrine of *Gregory v. Helvering*, 293 U.S. 465, since the form of the loan transactions to MacKay reflected their substance. All of the documentation was that of debt, the loans were

disproprotionate to stockholdings and unrelated parties testified they were unconditional loans intended to be repaid and this testimony should have been accepted since it was not inherently improbable. *Quock Ting v. United States*, 140 U.S. 417.

2. The decision of the Fifth Circuit is in conflict with the decisions of this Court. *The Kelley Company v. Commissioner, supra*, wherein it is stated:

> "As material amounts of capital were invested in stock, we need not consider the effect of extreme situations such as nominal stock investments and an obviously excessive debt structure."

A material amount of capital; namely, $30,000.00 was invested in the stock of MacKay, including an operating foundry and, therefore, the Fifth Circuit erred in determining that the loans to MacKay were capital contributions.

3. The decision of the Fifth Circuit is in conflict with *Commissioner v. Brown, supra*, wherein this Court stated:

> "Generally speaking, the language in the Revenue Act, just as in any statute, is to be given its ordinary meaning, and the words 'sale' and 'exchange' are not to be read any differently."

The same is true of the words "debt" and "business" and "proximately related" as used in Section 166 of the Internal Revenue Code. The definitions of the Fifth Circuit of "debt," "business," and "proximately related" do not conform to the ordinary meaning of those words, and, therefore, its decision is in conflict with this Court's decision in the *Brown* case.

E. Statutes and Rules Authorizing District Court Judges to Sit on Courts of Appeal Are Unconstitutional

Article II, Section 2 of the Constitution of the United States gives the President the power to appoint judges with the advice and consent of the Senate, as follows:

> "* * * and he shall nominate, and by and with the Advice and Consent of the Senate, shall appoint Ambassadors, other public Ministers and Consuls, Judges of the Supreme Court, and all other Officers of the United States, whose Appointments are not herein otherwise provided for, and which shall be established by Law; but the Congress may by Law vest the Appointment of such inferior Officers, as they think proper, in the President alone, in the Courts of Law, or in the Heads of Departments."

Because exclusive power of appointing Circuit Court Judges is given to the President with the advice and consent of the Senate, Section 292(a) of Title 28 U.S.C.A., which provides:

> "The chief judge of a circuit may designate and assign one or more district judges within the circuit to sit upon the court of appeals or a division thereof whenever the business of that court so requires * * *,"

and Section 43(b) of Title 28 U.S.C.A., which provides:

> "* * * the circuit justice and justices or judges assigned shall also be competent to sit as judges of the court."

and Rule 36 of the Rules of the United States Court of Appeals for the Fifth Circuit which permits such designation are all unconstitutional.

These laws and rules usurp the right of the President with the advice and consent of the Senate to appoint Circuit

Court Judges and give to the Chief Judge of a Circuit the right to appoint a District Court Judge to serve as a Circuit Court Judge contrary to Article II, Section 2 set out above.

The case of *Lamar v. United States*, 241 U.S. 103, is not contrary to the above contention since in that case the question was whether the assignment of a Judge of one District and one Circuit to perform duty in another Circuit was a usurpation of the power of appointment and confirmation vested by the Constitution in the President and the Senate. This Court held that it was not.

In the instant case a Judge appointed and confirmed as a District Court Judge is permitted by the statutes set out above to act as a Circuit Judge and this is a usurpation of the power of appointment and confirmation vested by the Constitution in the President and the Senate. Therefore, the statutes and rules set out above, and the rules of the Fifth Circuit and all other statutes and rules and regutions which authorize United States District Court Judges to sit as Circuit Court Judges are unconstitutional.

These statutes and rules are also unconstitutional because they deny petitioner due process of law provided for in the Fifth Amendment of the Constitution which provides:

> "* * * nor be deprived of life, liberty or property without due process of law; * * *"

What happened in the instant case dramatically illustrates how petitioner was deprived of property without due process of law by the statutes and rules set out above since one

of the panel of Judges who heard and decided petitioner's case was a District Court Judge who had decided a case as a District Court Judge involving the same issue and that decision was on appeal to the Fifth Circuit when this case was argued and tried. Petitioner was certainly deprived of due process of law by having her case heard and decided by such a District Judge and the statutes and rules which permitted this are unconstitutional since they can operate and did operate in the instant case to deprive the petitioner of her property without due process of law contrary to the Fifth Amendment.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

WRIGHT MATTHEWS,

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Attorneys for Petitioner.

CERTIFICATE OF SERVICE

We, Wright Matthews and Robert K. Sands, attorneys for Petitioner, Simon W. Henderson, Jr., Independent Executor for the Estate of Louise R. Henderson, Deceased, certify that four (4) copies of the foregoing petition for a writ of certiorari to the United States Court of Appeals for the Fifth Circuit were served on each of the following by depositing the same in a United States Post Office, postage prepaid, this 31st day of August, 1967:

(1) Solicitor General
Department of Justice
Washington, D.C.

(2) Honorable Mitchell Rogovin
Assistant Attorney General
Washington, D.C.

(3) Honorable William Wayne Justice
United States Attorney
Post Office Building
Tyler, Texas

Wright Matthews
Wright Matthews,

Robert K. Sands
Robert K. Sands,
Attorneys for Petitioner.

APPENDIX A

Statutes

28 U.S.C.A. 42:

"*Section 1254. Courts of appeals; certiorari; appeal; certified questions*

"Cases in the courts of appeals may be reviewed by the Supreme Court by the following methods:

"(1) By writ of certiorari granted upon the petition of any party to any civil or criminal case, before or after rendition of judgment or decree;

Internal Revenue Code of 1954:

"Sec. 166. Bad Debts.

"(a) *General Rule.*—

"(1) *Wholly worthless debts.*—There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

"(2) *Partially worthless debts.*—When satisfied that a debt is recoverable only in part, the Secretary or his delegate may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

* * *

"(d) *Nonbusiness Debts.*—

"(1) *General rule.*—In the case of a taxpayer other than a corporation—

"(A) subsections (a) and (c) shall not apply to any nonbusiness debt; and

"(B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months.

"(2) *Nonbusiness debt defined.*—For purposes of paragraph (1), the term 'nonbusiness debt' means a debt other than—

"(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

"(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business."

Regulations

"Sec. 1.166-1. Bad debts.

"(a) *Allowance of deduction.* Section 166 provides that, in computing taxable income under section 63, a deduction shall be allowed in respect of bad debts owed to the taxpayer. For this purpose, bad debts shall, subject to the provisions of section 166 and the regulations thereunder, be taken into account either as—

"(1) A dedution in respect of debts which become worthless in whole or in part; or as

"(2) A deduction for a reasonable addition to a reserve for bad debts."

"Sec. 1.166-5. Nonbusiness debts.

"(a) *Allowance of deduction as capital loss.* (1) The loss resulting from any nonbusiness debt's becoming partially or wholly worthless within the taxable year shall not be allowed as a deduction under either section 166(a) or section 166(c) in determining the taxable income of a taxpayer other than a corporation. See section 166(d) (1) (A).

"(2) If, in the case of a taxpayer other than a corporation, a nonbusiness debt becomes wholly worthless within the taxable year, the loss resulting therefrom shall be treated as a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months. Such a loss is subject to the limitations provided in section 1211, relating to the limitation on capital losses, and section 1212, relating to the

capital loss carryover, and in the regulations under those sections. A loss on a nonbusiness debt shall be treated as sustained only if and when the debt has become totally worthless, and no deduction shall be allowed for a nonbusiness debt which is recoverable in part during the taxable year.

"(b) *Nonbusiness debt defined.* For purposes of section 166 and this section, a nonbusiness debt is any debt other than—

"(1) A debt which is created, or acquired, in the course of a trade or business of the taxpayer, determined without regard to the relationship of the debt to a trade or business of the taxpayer at the time when the debt becomes worthless; or

"(2) A debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

The question whether a debt is a nonbusiness debt is a question of fact in each particular case. The determination of whether the loss on a debt's becoming worthless has been incurred in a trade or business of the taxpayer shall, for this purpose, be made in substantially the same manner for determining whether a loss has been incurred in a trade or business for purposes of section 165(c)(1). For purposes of subparagraph (2) of this paragraph, the character of the debt is to be determined by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt comes within the exception provided by that subparagraph. The use to which the borrowed funds are put by the debtor is of no consequence in making a determination under this paragraph. For purposes of section 166 and this section, a nonbusiness debt does not include a debt described in section 165(g)(2)(C). See section 1.165-5, relating to losses on worthless securities."

APPENDIX B

Opinion of the United States District Court, Eastern District of Texas, Tyler Division, No. 2945

August 6, 1964

232 F. Supp. 1

Simon W. Henderson, Jr., Independent Executor for the Estate of Louise R. Henderson, Deceased, Plaintiff,

v.

U. S., Defendant.

Wright Matthews, 2520 Republic Nat. Bk. Bldg., Dallas 1, Tex., Atty. for Plaintiff.

Wm. Wayne Justice, U.S. Atty., Tyler, Tex., Stanley F. Krysa, Tax Div., Dept. of Justice, 416-422 U.S. Courthouse, Ft. Worth, Tex., for Defendant.

Findings of Fact and Conclusions of Law

Statement

SHEEHY, District Judge:

This is an action for refund of income taxes in the amount of $267,513.16 plus interest in the amount of $37,258.17, paid for the taxable years 1953 through 1959, timely filed in this Court on November 1, 1961, by Louise R. Henderson, a widow, hereinafter referred to either as the "taxpayer" or as "Mrs. Henderson." Mrs. Henderson, who resided in Lufkin, Angelina County, Texas, at all times hereto pertinent, died on December 5, 1963, and on January 2, 1964, this Court entered an order herein substituting her son, Simon W. Henderson, Jr., Independent Executor of the Estate of

Louise R. Henderson, Deceased, as Plaintiff. The cause of action for the year 1957 is predicated upon the alleged erroneous act of the Commissioner of Internal Revenue in disallowing as an ordinary deduction an alleged business bad debt in the amount of $455,000.00 which became worthless in the year 1957. The other years are involved by virtue of carrying back and carrying forward the alleged business bad debt loss sustained in the year 1957.

The Plaintiff contends that Mrs. Henderson, acting through her son, Simon W. Henderson, Jr., who had her general power of attorney since November 8, 1927, during the period involved, was in the business of making loans and/or was in the business of organizing, financing and operating corporations and business ventures, and that during the years 1953 through 1957 Mrs. Henderson loaned a total of $455,000.00 to the MacKay Foundry, Inc., a corporation in which she was a stockholder, all of which loans became worthless in 1957, and that as a result thereof she was entitled to an ordinary deduction of $455,000.00 for the year 1957 with carryback and carryforward privileges under the authority of Sections 165 and 166 of the Internal Revenue Code of 1954 (26 U.S.C.A. ¶¶165 and 166).

In general the Defendant contends that any and all advances of funds made by Mrs. Henderson to the MacKay Foundry, Inc., were not loans but were contributions to capital; that during the years involved Mrs. Henderson was not in the business of making loans and/or organizing, financing and operating corporations; that if the advances made to MacKay Foundry, Inc., legally constituted loans, they

did not become worthless in 1957 but were worthless when incurred, and any claims for the years 1953 and 1954 were barred by the statutes of limitation; and that if Mrs. Henderson was in the business of making loans and/or organizing, managing and operating corporations, the alleged loans to MacKay Foundry, Inc., were not made pursuant to such business.

On January 21, 1963, the parties hereto, acting by and through their attorneys of record, executed a Stipulation of Facts and filed same in this cause on January 28, 1963. Said Stipulation of Facts, which hereinafter will be referred to as the "Stipulation of Facts," is adopted and made a part hereof.

The controlling contested issues of fact are as set out in Paragraph 3 of the Pre-Trial Order entered in this cause on January 28, 1963, to which reference is here made.

The Court, having considered and studied the lengthy record in this cause and the excellent briefs filed by the parties, makes the following Findings of Fact and Conclusions of Law:

Findings of Fact

1 through 62

Paragraphs I through LXII of the Stipulation of Facts filed in this cause on January 28, 1963, and above referred to, are hereby adopted as Findings of Facts Nos. 1 through 62, respectively.

63. Each of the notes evidencing the loans made by the Lufkin National Bank to MacKay Foundry, Inc., as set forth in Paragraph XX of the Stipulation of Facts, was endorsed by Simon W. Henderson, Jr., acting on behalf of his mother and not in his individual capacity. This indebtedness of MacKay Foundry, Inc., to the Lufkin National Bank was paid by Mrs. Henderson on November 7, 1955, by Mrs. Henderson's check in the amount of $62,000.00 being delivered to MacKay Foundry, Inc., and MacKay Foundry, Inc., in turn issuing its check to the bank for the amount of said indebtedness plus interest. Mrs. Henderson's check stub for the check issued to the Foundry in the amount of $62,000.00 was marked "loan."

64. Mrs. Henderson and MacKay Foundry, Inc., intended that the $62,000.00 advanced by Mrs. Henderson to MacKay Foundry, Inc., with which to pay the indebtedness of MacKay Foundry, Inc., to the Lufkin National Bank be a loan from Mrs. Henderson to the Foundry, and such, in truth and in fact, was a loan from Mrs. Henderson to the Foundry in the amount of $62,000.00 and was not either a capital contribution or a gift to MacKay Foundry, Inc.

65. Each of the advancements of funds by Mrs. Henderson to MacKay Foundry, Inc., set forth in Paragraph XXI of the Stipulation of Facts, was intended by Mrs. Henderson and MacKay Foundry, Inc., to be a loan from Mrs. Henderson to MacKay Foundry, Inc., in the amount of said advancement, which would be repaid, and was, in truth and in fact, a loan from Mrs. Henderson to MacKay Foundry,

Inc., and was not either a capital contribution or a gift to MacKay Foundry, Inc.

66. The decision to cease the operation of MacKay Foundry, Inc., referred to in Paragraph XXIV of the Stipulation of Facts, was made by the Board of Directors of MacKay Foundry, Inc.

67. At the time the MacKay plant ceased operations in March 1957, it did not own the land and buildings in which its operations were conducted but was bound by a lease having a ten year term beginning on May 1, 1953. The Lessor of said lease was the Texas Southeastern Railroad Company, a Texas corporation. Under the terms of that lease, which was dated March 6, 1953, the MacKay Foundry, Inc., obligated itself to pay a monthly rental of $267.00 for a period of ten years beginning May 1, 1953, or, in the alternative, the company could exercise an option to purchase the plant site and original buildings included in the above lease on any anniversary date of the lease at stipulated amounts ranging from $26,000.00 at the end of the first year to $14,800.00 at the end of the tenth year. MacKay Foundry, Inc., the Lessee under the provisions of the lease, gave the Lessor a lien upon all additions to the lease property as well as any personal property placed thereon as security for the monthly rentals. That lease further provided that if MacKay defaulted in any payment of rent, or if execution should be issued against MacKay or if bankruptcy proceedings should be begun or against MacKay, or if any assignment be made by MacKay for the benefit of creditors or if a receiver is appointed, the entire rent for the balance of

the lease term would, at the option of the Lessor, be due and payable. In addition, the MacKay Foundry, Inc., agreed, among other things, that at the expiration of the term of the lease all additions to the property would belong to the Lessor.

68. At the time the operations of MacKay Foundry, Inc., ceased in March of 1957, the aforementioned lease had been in effect from May 1, 1953, for a period of three years and eleven months and the remaining term of said lease on March 31, 1957, was six years and one month. On March 31, 1957, the total lease liability amounted to seventy-three months at $267.00 per month, or a total lease liability of $19,291.00. On December 31, 1957, the total lease liability amounted to sixty-four months at $267.00 per month, or a total lease liability of $17,088.00.

69. During the month of December 1957 the market value of all of the machinery and equipment owned by MacKay Foundry, Inc., did not exceed the sum of $8,700.00.

70. In an agreement of merger dated April 21, 1958, whereby MacKay Foundry, Inc., agreed to merge with the Indiana Foundry Corporation, an Indiana corporation, it was agreed that Indiana would not be subject to and would have no liability under the lease from Texas Southeastern Railroad Company to MacKay Foundry, Inc., referred to in Finding of Fact No. 67 above. To satisfy the requirement of Indiana with respect to the lease liability, MacKay

Foundry, Inc., on April 30, 1958, with the approval of Texas Southeastern Railroad Company transferred its lease liability to Mrs. Henderson. On May 23, 1958, Mrs. Henderson exercised the option under the lease and acquired all of the land and buildings constituting the leasehold premises by paying the sum of $21,600.00 therefor. Pursuant to the Articles of Merger executed by MacKay Foundry, Inc., and Indiana Foundry Corporation all of the assets of the MacKay Foundry became the property of Indiana. However, said Articles of Merger provided that all equipment not removed from the MacKay Foundry premises by July 1, 1958, would become the property of the owner or lessee of said premises. This deadline for the removal of equipment was later extended by the parties to August 1, 1958. Indiana failed to remove any of the machinery or equipment from the MacKay plant with the exception of a "payloader" which had a value of $150.00. Therefore, on August 1, 1958, the equipment and machinery theretofore belonging to the MacKay Foundry became the property of Mrs. Henderson.

71. In October 1958 Mrs. Henderson, acting through her son, loaned some ornamental iron patterns to the Indiana Foundry Corporation. Thus as a result of the merger Indiana received from the MacKay Foundry only the payloader, above referred to, and the loan of some ornamental iron patterns which had no market value.

72. Subsequent to August 1, 1958, Mrs. Henderson, acting through her son, sold all of the assets of MacKay Foundry, Inc., which assets she had acquired title to on August 1, 1958, as set forth in Finding of Fact No. 70 above, for approximately $8,700.00.

73. The assets referred to in the Finding of Fact next above were not available on December 31, 1957, or at any other time during 1957 to apply on MacKay's indebtedness of $455,000.00 to Mrs. Henderson since they were subject to a lien in favor of Texas Southeastern Railroad Company, as set forth in Finding of Fact No. 67 above, and any law suit by Mrs. Henderson against MacKay Foundry, Inc., to collect the $455,000.00 owed her by MacKay Foundry, Inc., would have resulted in an uncollectible judgment.

74. In February 1962 Mrs. Henderson sold the land and buildings previously occupied and used by the MacKay Foundry, Inc., to the Lufkin Pecan Shelling Company, which company was not engaged in the foundry business or any similar business, for $5,000.00 in cash and $22,500.00 in promissory notes.

75. The total liabilities of MacKay Foundry, Inc., including the lease liability owed to the Texas Southeastern Railroad Company, but exclusive of the $455,000.00 indebtedness owed to Mrs. Henderson, exceeded the assets of MacKay Foundry, Inc., on March 31, 1957, and at all times thereafter including December 31, 1957, and there were no assets

available to satisfy any part of the $455,000.00 owed to Mrs. Henderson on March 31, 1957, and any time thereafter through December 31, 1957.

76. Simon W. Henderson, Jr., acting for his mother, decided in December 1957 that the indebtedness of MacKay Foundry, Inc., to his mother in the amount of $455,000.00 was worthless and accordingly instructed his mother's bookkeeper to charge off in December 1957 the entire $455,000.00 indebtedness. Such chargeoff was made on Mrs. Henderson's books as of December 31, 1957, although the actual physical entries, whereby said indebtedness was charged off, were made by Mrs. Henderson's bookkeeper in the regular course of closing Mrs. Henderson's books sometime in January 1958 but prior to January 31, 1958.

77. MacKay Foundry, Inc., never made a payment on its indebtedness of $455,000.00 to Mrs. Henderson, and since March 1957 there has been no expectation that any payment on said indebtedness would or will be made.

78. None of the loans made by Mrs. Henderson to MacKay Foundry, Inc., referred to in Findings of Fact Nos. 64 and 65, above, was worthless at the time it was made.

79. At the times the loans, referred to in Findings of Fact Nos. 64 and 65, above, were made on behalf of Mrs. Henderson to MacKay Foundry, Inc., neither Mrs. Henderson nor Simon W. Henderson, Jr. knew or believed that such loans would not be repaid.

80. The entire $455,000.00 indebtedness of MacKay Foundry, Inc., to Mrs. Henderson became worthless in 1957.

81. During all of the year 1957, including December 31, Mrs. Henderson was the owner of the notes of MacKay Foundry, Inc., evidencing its $455,000.00 indebtedness to Mrs. Henderson.

82. During the years 1953 through 1959, and for a long time prior thereto, Mrs. Henderson was engaged in the trade or business of lending money. Each of the loans made by Mrs. Henderson to MacKay Foundry, Inc., and referred to in Findings of Fact Nos. 64 and 65, above, was made by Mrs. Henderson pursuant to the carrying on of her business of lending money and had a proximate relation to Mrs. Henderson's trade or business of lending money.

83. The evidence fails to establish that Mrs. Henderson at any time during the years 1953 through 1957 was engaged in the business of organizing, financing and managing corporations.

84. As reflected by Paragraphs XIV and XXIII of the Stipulation of Facts, Mrs. Henderson on January 1, 1957, was the owner of 170 shares of stock in MacKay Foundry, Inc., having a cost basis of $14,500.00, which stock had been held and owned by her as a capital asset for more than six months on said date.

85. The 170 shares of capital stock of MacKay Foundry, Inc., owned by Mrs. Henderson, as set forth in the Finding of Fact next above, became worthless in 1957.

Conclusions of Law

1. The Court has jurisdiction of this cause pursuant to the provisions of Section 1346(a)(1) and 1402(a) of Title 28, U.S.C.A.

2. The advances totaling $455,000.00 made by Mrs. Henderson to the MacKay Foundry, Inc., as hereinabove set forth, were loans and were not capital contributions.

3. During the years 1953 through 1959 Mrs. Henderson was engaged in the trade or business of lending money.

4. The loans totaling $455.000.00 and each of them, made by Mrs. Henderson to the MacKay Foundry, Inc., had a proximate relation to Mrs. Henderson's trade or business of lending money.

5. MacKay Foundry, Inc.'s indebtedness to Mrs. Henderson in the amount of $455,000.00, which became worthless in 1957, is a business bad debt within the meaning of Section 166(a)(1) of the Internal Revenue Code of 1954 (26 U.S.C.A. 166(a)(1)) which Mrs. Henderson was entitled to take as an income tax deduction in 1957 with the carry-back and carry-forward privileges provided for by the Internal Revenue Code of 1954.

6. Mrs. Henderson's 170 shares of stock in MacKay Foundry, Inc., having a cost basis of $14,500.00, having become worthless in 1957, as hereinabove found, Mrs. Henderson was entitled to a long term capital loss deduction for

the year 1957 in the amount of $14,500.00 with the carry-forward privileges provided for by the Internal Revenue Code of 1954.

Judgment to be Entered

In light of the Findings and Conclusions hereinabove made, Plaintiff is entitled to recover in this cause. The parties, pursuant to the stipulation contained in the Pre-Trial Order entered in this cause on January 28, 1963, should compute the amount of refunds due Plaintiff for the years involved in light of the Findings and Conclusions above made. Upon such computation being made and filed as a part of the record in this cause, judgment will be entered allowing Plaintiff a recovery against Defendant in the amount of such refunds due Plaintiff as reflected by such computation with interest as provided by law.

FILED
.....M. August 18, 1964
James R. Cooney, Clerk, U.S. Court
By Hazle Johnson, Deputy

IN THE DISTRICT COURT OF THE UNITED STATES
For the Eastern District of Texas
Tyler Division

Civil No. 2945

SIMON W. HENDERSON, JR.,
Independent Executor for the Estate of
LOUISE R. HENDERSON, Deceased,

Plaintiff,

v.

UNITED STATES OF AMERICA,

Defendant.

JUDGMENT

This cause having come on for hearing before the Court, sitting without jury, the Court having considered stipulations of the parties, testimony of the witnesses, and the oral arguments and briefs of counsel, having entered findings of fact and conclusions of law for the plaintiff, it is therefore:

ORDERED, ADJUDGED and DECREED that plaintiff recover against the defendant SIXTY THOUSAND FOUR HUNDRED NINETY-SEVEN DOLLARS AND EIGHTY-SEVEN CENTS ($60,497.87) representing an overpayment of

Federal income tax for the calendar year 1955 in the amount of FIFTY-ONE THOUSAND SEVEN HUNDRED FIFTY-FOUR DOLLARS AND THIRTY-SIX CENTS ($51,754.36) and interest for said calendar year of EIGHT THOUSAND SEVEN HUNDRED FORTY-THREE DOLLARS AND FIFTY-ONE CENTS ($8,743.51), plus interest as provided by law on such amount. Plaintiff paid said Federal income taxes and interest totalling SIXTY THOUSAND FOUR HUNDRED NINETY-SEVEN DOLLARS AND EIGHTY-SEVEN CENTS ($60,497.87) to defendant on November 7, 1960.

ORDERED, ADJUDGED and DECREED that plaintiff recover against the defendant FIFTY-EIGHT THOUSAND EIGHT HUNDRED NINETY-NINE DOLLARS AND FOUR CENTS ($58,899.04) representing an overpayment of Federal income tax for the calendar year 1956 in the amount of FIFTY THOUSAND TWO HUNDRED EIGHTY-ONE DOLLARS AND SIXTY CENTS ($50,281.60) and interest for said calendar year of EIGHT THOUSAND SIX HUNDRED SEVENTEEN DOLLARS AND FORTY FOUR CENTS ($8,617.44), plus interest as provided by law on such amount. Plaintiff paid said Federal income taxes and interest totalling FIFTY-EIGHT THOUSAND EIGHT HUNDRED NINETY-NINE DOLLARS AND FOUR CENTS ($58,899.04) to defendant on November 7, 1960.

ORDERED, ADJUDGED and DECREED that plaintiff recover against the defendant NINETY-FOUR THOU-

SAND FOUR HUNDRED FIFTY-NINE DOLLARS AND EIGHTY-ONE CENTS ($94,459.81), representing an overpayment of Federal income tax for the calendar year 1957 in the amount of EIGHTY-TWO THOUSAND THREE HUNDRED SIXTY-SEVEN DOLLARS AND TWENTY-SIX CENTS ($82,367.26) and interest for said calendar year of TWELVE THOUSAND NINETY-TWO DOLLARS AND FIFTY-FIVE CENTS ($12,092.55), plus interest as provided by law on such amount. Plaintiff paid Federal income taxes and interest totalling ONE HUNDRED FIVE THOUSAND FOUR HUNDRED TWENTY-NINE DOLLARS AND TWENTY-FOUR CENTS ($105,429.24) to defendant on November 7, 1960 representing NINETY-ONE THOUSAND FIVE HUNDRED SEVEN DOLLARS AND FIFTY-SIX CENTS ($91,507.56) in Federal income tax and THIRTEEN THOUSAND NINE HUNDRED TWENTY-ONE DOLLARS AND SIXTY-EIGHT CENTS ($13,921.68) in interest and has been refunded TEN THOUSAND NINE HUNDRED SIXTY-NINE DOLLARS AND FORTY-THREE CENTS ($10,969.43) which consisted of NINE THOUSAND ONE HUNDRED FORTY DOLLARS AND THIRTY CENTS ($9,140.30) in Federal income tax and ONE THOUSAND EIGHT HUNDRED TWENTY-NINE DOLLARS AND THIRTEEN CENTS ($1,829.13) in interest, leaving a balance to be refunded of NINETY-FOUR THOUSAND FOUR HUNDRED FIFTY-NINE DOLLARS AND EIGHTY-ONE CENTS ($94,459.81).

ORDERED, ADJUDGED and DECREED that plaintiff recover against the defendant FIFTY-THREE THOUSAND EIGHT HUNDRED DOLLARS AND SIXTY-THREE CENTS ($53,800.63) representing an overpayment of Federal income tax for the calendar year 1958 in the amount of FORTY-NINE THOUSAND TWO HUNDRED SIXTY-ONE DOLLARS AND EIGHTY CENTS ($49,261.80) and interest for said calendar year of FOUR THOUSAND FIVE HUNDRED THIRTY-EIGHT DOLLARS AND EIGHTY-THREE CENTS ($4,538.83), plus interest as provided by law on such amount. Plaintiff paid said Federal income taxes and interest totalling FIFTY-THREE THOUSAND EIGHT HUNDRED DOLLARS AND SIXTY-THREE CENTS ($53,800.63) to defendant on November 7, 1960.

ORDERED, ADJUDGED and DECREED that plaintiff recover against the defendant THIRTY-TWO THOUSAND FOUR HUNDRED EIGHTY-SEVEN DOLLARS AND SIXTY-FOUR CENTS ($32,487.64) representing an overpayment of Federal income tax for the calendar year 1959 in the amount of THIRTY-ONE THOUSAND FIFTY DOLLARS AND NINETY-THREE CENTS ($31,050.93) and interest for said calendar year of ONE THOUSAND FOUR HUNDRED THIRTY-SIX DOLLARS AND SEVENTY-ONE CENTS ($1,436.71), plus interest as provided by law on such amount. Plaintiff paid TWENTY-SIX THOUSAND ONE HUNDRED FORTY-FOUR DOLLARS AND FIFTY-FIVE CENTS ($26,144.55) of said Federal income taxes and interest to defendant on April 3, 1961. The remainder of

said overpayment was paid to defendant on April 15, 1960 and with plaintiff's 1959 Declaration of Estimated Tax.

ORDERED, ADJUDGED and DECREED that plaintiff recover against the defendant its costs as follows by law.

/s/ JOE W. SHEEHY
United States District Judge

ENTERED this 18th day of August, 1964.

Approved as to form:

/s/ WRIGHT MATTHEWS

/s/ ROBERT K. SANDS
Counsel for Plaintiff

/s/ STANLEY F. KRYSA
Counsel for Defendant

In the

UNITED STATES COURT OF APPEALS

For the Fifth Circuit

No. 22152

UNITED STATES OF AMERICA,

Appellant,

versus

SIMON W. HENDERSON, JR.,
Independent Executor for the Estate of
LOUISE R. HENDERSON, Deceased,

Appellee.

Appeal from the United States District Court for the Eastern District of Texas.

(March 23, 1967.)

Before JONES and COLEMAN, Circuit Judges, and JOHNSON, District Judge.

JOHNSON, District Judge: This is an appeal by the United States from an adverse judgment in an action brought against it by Louise R. Henderson[1] for refund of income taxes and interest in the amount of $300,144.99 for the taxable years 1953 through 1959.

Sometime in 1953, Simon Henderson, Jr., who exercised a power of attorney for taxpayer during the period in ques-

[1] Louise R. Henderson died prior to trial, and Simon W. Henderson, Jr., her independent executor, was substituted as plaintiff and is appellee herein.

tion, decided to help taxpayer's grandson-in-law (and Henderson's son-in-law), Malcolm Alexander, get started in business in Lufkin, Texas. With the idea there was a demand in Texas for top grade gray iron castings, it was decided to invest in a local foundry which, with new equipment, was capable of producing this particular type of casting. A new corporation, MacKay Foundry, Inc., was formed for this purpose, with its $30,000.00 of common stock issued in the amount of $7,000.00 to Alexander, $1,000.00 to Henderson, $7,000.00 to taxpayer, and the remainder in varying amounts to three other individuals. The participants in MacKay understood that the additional financing for new equipment that MacKay required would come from Henderson and taxpayer.

Between April 14, 1953, and July 14, 1953, MacKay obtained four loans from the Lufkin National Bank totaling $60,000.00, at four percent interest, evidenced by four notes, each of which was endorsed by Henderson under his power of attorney from taxpayer. Although MacKay was operating at a loss, Henderson, again on behalf of taxpayer, made two advances to MacKay in the total amount of $55,000.00, at four percent interest in July, 1953. There was no security for the advances since Henderson seemed to think that MacKay would prosper, and it was generally understood that taxpayer would not be paid back until MacKay showed a profit. During the remainder of 1953, taxpayer made additional advances of $24,100.00.

MacKay continued to lose money. Reynolds, production manager, was forced to resign, and his one-third interest

was bought by taxpayer for $7,500.00. Still the corporation continued to lose money, and had losses of $45,000.00 in 1954, $92,000.00 in 1955, and $125,000.00 in 1956. Yet taxpayer continued to advance MacKay money: $94,000.00 in 1954, $137,000.00 (which included a $62,000.00 advance that MacKay used to repay its indebtedness to the Lufkin National Bank) in 1955, and $145,000.00 in 1956.

In 1957, MacKay ceased operating. All of its creditors received payment in full with the exception of taxpayer.

Subsequent to the cessation of MacKay's operations, MacKay was merged with Indiana Foundry Corporation. The "notes" which MacKay had issued to taxpayer were endorsed in blank and delivered to one of the attorneys negotiating the merger with Indiana Foundry. Thereafter, Indiana Foundry issued its stock for that of MacKay. In 1961, Indiana Foundry redeemed this stock, thereby terminating the interest of taxpayer in the two merged companies. Although the other stockholders turned over the proceeds of the redemption to taxpayer, Alexander and Henderson kept theirs, which resulted in a 100 percent gain over what they had paid for this stock.

On her federal income tax return for 1957, the taxpayer deducted in full from ordinary income the $455,000.00 that she had advanced to MacKay during the years 1953 to 1956. The net operating loss that resulted from this deduction was carried back to the years 1955 and 1956 and forward to the year 1958, and was deducted from her income for those years. The Commissioner of Internal Revenue disallowed this deduction on the grounds that the advances to MacKay

constituted capital investments in its business rather than indebtedness, so that the loss resulting from their worthlessness was deductible only as a capital loss under Section 165(g), 26 U.S.C., Internal Revenue Code of 1954,[2] and that even if the advances constituted indebtedness under Section 166(d),[3] the loss resulting from their worthlessness

[2] Section 165(g) provides:

"(g) *Worthless Securities.*—

(1) *General rule.*—if any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall, for purposes of this subtitle, be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset.

(2) *Security defined.*—For purposes of this subsection, the term "security" means—

(A) a share of stock in a coporation;"

[3] Section 166 provides:

"BAD DEBTS.

(a) *General Rule.*—

(1) *Wholly worthless debts.*—There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

(2) *Partially worthless debts.*—When satisfied that a debt is recoverable only in part, the Secretary or his delegate may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

(d) *Nonbusiness Debts.*—

(1) *General Rule.*—In the case of a taxpayer other than a corporation—

(A) subsections (a) and (c) shall not apply to any nonbusiness debt; and

(B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months.

(2) *Nonbusiness bad debts defined.*—For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than—

(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

was still deductible only as a capital loss because they were non-business bad debts.

The District Court reversed, holding that taxpayer's advances to MacKay constituted indebtedness, that during the years 1953 through 1956 taxpayer was engaged in the business of lending money, and that the advances to MacKay were made in pursuance of this business of lending money.

We reverse the District Court.

I

Although there is a plethora of precedent on the question of whether advances by a stockholder to a closely held corporation are to be considered as debts or contributions to capital, no single principle or test is controlling or decisive in making this determination. See, for example *Montclair, Inc. v. Commissioner*, 318 F. 2d 38, 40 (5th Cir. 1963). Perhaps the most important underlying principle is that no valid debt exists unless there is an unconditional obligation of another to pay the taxpayer a definite sum of money, and, in the context of the present case, that the taxpayer insists, together with the other creditors, on sharing in the assets of the corporation for repayment at any time when the corporation may be liquidated. *See* Mertens, Law of Federal Income Taxation, ¶30.03. Thus, evidence which courts have found to be indicative of a contribution to capital rather than a cash advance includes: that the cash advances were made to commence the corporate life, that repayment was subordinated to other indebtedness, that a fixed maturity date was absent, that the corporation was inadequately capitalized,

that the parties agreed not to enforce collection, that interest was to be paid out of earnings only, and that those making advances had voting power in the corporation. *See Sun Properties, Inc. v. United States*, 220 F. 2d 171, 175-76 (5th. Cir. 1955); *Aqualane Shores, Inc. v. Commissioner*, 269 F. 2d 116 (5th Cir. 1959); *Montclair, Inc. v. Commissioner, supra; United States v. Synder Bros. Co.*, ... F. 2d .... (5th Cir. July 26, 1966).

In the present case, appellee stresses that there was a clear intention on the part of the corporation to repay these notes, that MacKay was unconditionally bound to pay definite sums at fixed dates regardless of earnings, and that taxpayer was not interested in sharing the profits of the corporation beyond interest on the notes. In particular, taxpayer points to the form of the notes and the manner in which these transactions were handled by taxpayer and MacKay on their respective books as evincing indebtedness rather than contributions to capital.

Although the nomenclature and intent of the parties are important factors to take into account, it is clear that the nomenclature used and the intent of the taxpayer cannot alone control the tax consequences of a particular series of transactions. *Gregory v. Helvering*, 293 U.S. 465 (1935); *United States v. Synder Bros. Co., supra.* Moreover, we conclude that the facts and circumstances in this case belie any genuine intent to repay these sums at the dates fixed in the notes. The facts, which are in large part undisputed, simply do not support the findings and conclusions made by the trial court that the taxpayer satisfied her burden of proof.

First, during the years 1953 through 1956, the taxpayer made advances to MacKay even though MacKay continued to lose money and had failed to improve its competitive position in the iron casting market. While the majority of the "notes" evincing the advances became due during these years no part of the "interest" or "principal" was ever paid. In fact, it was generally understood that repayment was contingent upon the success of the business and that repayment was to be made only out of profits.

Second, taxpayer's advances were also subordinated to MacKay's indebtedness to its other creditors. While MacKay's obligations to the taxpayer were past due and unpaid, MacKay continued to pay all its obligations to its creditors. When MacKay finally ceased operations, all its creditors were paid in full, yet no such payments were ever made on the notes held by taxpayer.

Finally, although this Circuit has rejected the notion that thin capitalization will alone justify the commissioner in designating indebtedness as capital, *Rowan v. United States*, 219 F. 2d 51 (5th Cir. 1955), it is very strong evidence in a case such as this where (1) the debt to equity ratio was high to start with, (2) the parties understood that it would likely go higher, and (3) substantial portions of these funds were used for the purchase of capital assets and for meeting expenses needed to commence operations.

The sum total of these several factors make the conclusion inescapable that these transactions resulted in a contribution

to the capital of MacKay and did not create any genuine indebtedness within the meaning and scope of the relevant provisions of the Internal Revenue Code.

II

Even if we assume for purposes of argument that these transactions created a bona fide indebtedness, the evidence overwhelmingly reflects that taxpayer was not engaged in the trade or business of lending money within the meaning of Section 166, Internal Revenue Code, and thus taxpayer is not entitled to a bad debt deduction.

The guideposts for determining what constitutes a trade or business under Section 166(d)(2) are nearly as amphorous as those involved in distinguishing indebtedness from equity investments under Section 165(g) and again no single test or factor is determinative. In general, the activities constituting the trade or business must occupy a substantial amount of the taxpayer's time or of the time of taxpayer's employees, *see Snell v. Commissioner*, 97 F. 2d 891 (5th Cir. 1938), and these activities must be direct compensation for the taxpayer's activities or those of his employees. *See Higgins v. Commissioner*, 312 U.S. 212 (1941); *Whipple v. Commissioner*, 373 U.S. 193 (1963). Thus, in *Whipple*, holding that a taxpayer who performed services for a number of corporations did not ipso facto have a trade or business distinct from investment with the result that a

loan made to one of the corporations was a nonbusiness debt, the Court stated:

> When the only return is that of an investor, the taxpayer has not satisfied his burden of demonstrating that he is engaged in a trade or business since investment is not a trade or business and the return to the taxpayer though substantially the product of his services, legally arises not from his own trade or business but from that of the corporation, 373 U.S. at 202.

In seeking to establish that taxpayer was in the trade or business of making loans, taxpayer stresses her substantial loan-making activities both prior to and after the years involved herein. Taxpayer also points to the fact that substantial collection activity took place during the period, that extensive records were maintained, and that four witnesses testified that taxpayer had a reputation in the community for being in the lending business.

Although it is true that taxpayer may have been in the business of making loans during the periods in question, this Court is firm in its conclusion that taxpayer was not involved in a continuous course of conduct of making loans, the purpose of which was the derivation of profits. Aside from the loans to MacKay, there were only seven other loans made during this period, and only one of these was interest bearing. Neither the taxpayer nor anyone employed by her regularly devoted a significant portion of his time to the activities connected with the making of loans. Henderson, who managed not only the taxpayer's interests, but also a

lumber business, located elsewhere in Texas, devoted only a very small portion of his time to the servicing of these loans. Furthermore, other indicia of a genuine loan business were absent; neither the taxpayer nor anyone acting on her behalf ever actively sought out the loan business; taxpayer never advertised that she was in a business of lending and did not maintain an office for that purpose; taxpayer's activities in connection with the making of loans during this period were not treated as a business separate from her other interests—a separate office was not maintained, separate business books of account were not kept, and statements showing profit or loss from loan activities were not prepared; and, finally, most of the borrowing was either by social or business acquaintances.

III

Even if taxpayer was engaged in the trade or business of making loans, it is well established that the particular loan activities involved herein must be "proximately" related to her loan activities. Thus, in *United States v. Whipple*, *supra*, the Court stated:

> [The nonbusiness bad debt provision] was intended to accomplish far more than to deny full deductibility to the worthless debts of family and friends. It was designed to make full deductibility of a bad debt turn upon its proximate connection with activities which the tax laws recognized as a trade or business, a concept which falls far short of reaching every income or profit making activity. . . .

Even if taxpayer demonstrates an independent trade or business of his own, care must be taken to distinguish

> bad debt losses arising from activities peculiar to an investor concerned with, and participating in, the conduct of the corporate business. 373 U.S. at 201, 202.

Thus, if taxpayer could prevail upon the theory that these advances were loans as opposed to contributions to capital and, furthermore, if taxpayer had established that, during the years in question, she was in the business of making loans within the meaning of Section 166 of the Internal Revenue Code, the facts and circumstances surrounding the transactions in question clearly indicate these "loans" were not "proximately" related to her loan activities. For example, the evidence is quite strong that these advances were made with a view to helping taxpayer's grandson-in-law, Malcolm Alexander, get started in the foundry business in Lufkin. The record is replete with references to taxpayer's desire to see the business grow and prosper and to see young Alexander make a success of it. Prior to the creation of MacKay, taxpayer had expressed her desire to see Alexander get started in Lufkin, and offered financial assistance to the MacKay Corporation until it got off the ground. Even when the corporation was an obvious failure and Henderson had determined operations should be stopped, taxpayer expressed her regret and urged Henderson to provide further assistance and financing. Her motives, therefore, were clearly not those of an investor seeking the fair return of profit in connection with a money-lending business. This is underscored by the fact that taxpayer received no compensation for the risk she incurred in guaranteeing MacKay's obligations to the Lufkin National Bank and that the four percent interest rate that MacKay agreed to pay taxpayer—the

same rate that the bank had charged in a riskless situation (riskless because of taxpayer's guarantee)—was wholly disproportionate to the great risk which the taxpayer actually incurred. Moreover, as pointed out previously, the taxpayer did not treat these transactions as arms-length investment activity; she did not insist on her rights as a creditor; no interest or principal was ever paid since it was generally understood that interest and principal would be repayable only if and when the corporation had profits, whereas at the same time all other creditors were paid in full whenever MacKay's obligations to them fell due; and finally, after the merger with Indiana Foundry taxpayer allowed Henderson and Alexander to retain the proceeds they received from the subsequent stock redemption which resulted in a 100 percent gain to them over what they had originally invested in MacKay, even though not a cent was paid to her with respect to the notes which should have had first priority of satisfaction from MacKay's assets.

The judgement is REVERSED and the case is REMANDED to the District Court for the entry of judgment in favor of the United States.

UNITED STATES COURT OF APPEALS
For The Fifth Circuit

October Term 1966

No. 22152

D.C. Docket No. 2945—Civil Action

UNITED STATES OF AMERICA,
Appellant,

versus

SIMON W. HENDERSON, JR.,
Independent Executor for the Estate of
LOUISE R. HENDERSON, Deceased,
Appellee.

Appeal from the United States District Court for the Eastern District of Texas.

Before JONES and COLEMAN, Circuit Judges, and JOHNSON, District Judge.

JUDGMENT

This cause came on to be heard on the transcript of the record from the United States District Court for the Eastern District of Texas, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is hereby reversed; and that this cause be, and the same is hereby remanded to the said District Court for the entry of judgment in favor of the United States in accordance with the opinion of this Court.

March 23, 1967

Issued Mandate:

In the
UNITED STATES COURT OF APPEALS
For The Fifth Circuit

No. 22152

UNITED STATES OF AMERICA,

Appellant,

versus

SIMON W. HENDERSON, JR.,
Independent Executor for the Estate of
LOUISE R. HENDERSON, Deceased,

Appellee.

Appeal from the United States District Court
for the Eastern District of Texas

(June 13, 1967)

ON PETITION FOR REHEARING

Before JONES and COLEMAN, Circuit Judges, and JOHNSON, District Judge.

PER CURIAM

It is ORDERED that the appellee's Petition for Rehearing in the above entitled and numbered cause be, and the same is, hereby DENIED.

In the
UNITED STATES COURT OF APPEALS
For The Fifth Circuit

No. 22152

UNITED STATES OF AMERICA,
Appellant,

versus

SIMON W. HENDERSON, JR.,
Independent Executor for the Estate of
LOUISE R. HENDERSON, Deceased,
Appellee.

Appeal from the United States District Court for the Eastern District of Texas

(July 12, 1967)

ON PETITION FOR REHEARING EN BANC

Before JONES and COLEMAN, Circuit Judges, and JOHNSON, District Judge.

PER CURIAM

The petition for rehearing having been denied, and the petition for rehearing en banc having been submitted to each of the judges in active service on the court, and it appearing that no member of the court in regular active service on the court has requested that the court be polled on rehearing en banc, Rule 25a, Subparagraph B, the petition for rehearing en banc is DENIED.

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 22152

UNITED STATES OF AMERICA,

Appellant,

v.

SIMON W. HENDERSON, JR.,
Independent Executor for the Estate of
LOUISE R. HENDERSON, Deceased,

Appellee.

ON CONSIDERATION OF THE APPLICATION of the Appellee in the above numbered and entitled cause for a further stay of the mandate of this Court therein, to enable Appellee to apply for and to obtain a writ of certiorari from the Supreme Court of the United States. IT IS ORDERED that the issue of the mandate of this Court in said cause be and the same is further stayed to and including September 10, 1967, the stay to continue in force until the final disposition of the case by the Supreme Court, provided that within the period above mentioned there shall be filed with the Clerk of this Court the certificate of the Clerk of the Supreme Court that certiorari petition and record have been filed. It is further ordered that the Clerk shall issue the mandate upon the filing of a copy of an order of the Supreme Court denying the writ, or upon the expiration of the stay granted herein, unless the above mentioned certificate shall be filed with the Clerk of this Court within that time.

/s/ FRANK M. JOHNSON, JR.

Dated: August 3, 1967 *United States District Judge*

(ORIGINAL FILED—AUGUST 4, 1967)

APPENDIX C

Opinion of the United States District Court, Middle District of Alabama, Northern Division, No. 1887-N

July 19, 1965

245 F. Supp. 782

Frederick Henderson and Louise Henderson, Plaintiffs,

v.

U. S., Defendant.

Fred S. Ball, Jr., Ball & Ball, Suite 719, First Nat. Bk. Bldg., Montgomery, Ala., Robert D. Thorington, Melton H. Tankersley, Duke & Thorington, 1012-24 First Nat. Bk. Bldg., Montgomery, Ala., Attys. for Plaintiffs.

Ben Hardeman, U. S. Atty., Rodney R. Steele, Asst. U. S. Atty., Montgomery, Ala., Hubert M. Doster, Robert J. Tribbey, Tax Div., Dept. of Justice, Wash., D. C., for Defendant.

Memorandum Opinion

JOHNSON, JR., District Judge:

This is a statutory action for the recovery of income taxes in the amount of $6,528.73, plus interest, for the calendar year 1960. The case is submitted to the Court pursuant to a stipulation of the parties for decision solely on the basis

of the transcript of the proceedings of a former trial[1] held on November 19, 1964; upon this submission and upon consideration of the credible evidence, this Court as authorized by Rule 52, Federal Rules of Civil Procedure, incorporates the appropriate findings of fact and conclusions of law in this memorandum opinion.

The sole questions involved concern whether or not certain advances to Henderson Mining Company, Inc. by the plantiff, Frederick Henderson (Louise Henderson is a party only by reason of the fact that the tax return involved was filed jointly) during the taxable year ending May 31, 1960, were loans or contributions to capital. The subsidiary question, usual in such cases,[2] concerning whether the advances in effect created a separate class of stock is also involved in the present submission.

The evidence reflects that Frederick Henderson owned 60% of the stock of Henderson Mining Company, Inc., which was incorporated under the laws of Alabama in December, 1959,

[1] Upon the former trial, the factual issues were submitted to a jury upon special written interrogatories, as provided by Rule 49(a), Federal Rules of Civil Procedure, and the jury answered these interrogatories favorable to the plaintiffs. Upon the motion of the United States made pursuant to Rule 59, Federal Rules of Civil Procedure, this Court, by formal order of January 14, 1965, granted the motion and ordered a new trial. The present submission, by stipulation, on the basis of the transcript of the proceedings at the former trial, together with all exhibits which were received in evidence at such trial, is in lieu of the retaking of the testimony orally before the Court.

[2] United States v. Title Guarantee & Trust Co., 133 F. 2d 990; Rowan v. United States, 219 F. 2d 51; O. H. Kruse Grain & Milling Co. v. Commissioner, 279 F. 2d 123; Montclair, Inc. v. Commissioner, 318 F. 2d 38; Aronov Construction Company, Inc. v. United States, 223 F. Supp. 175 (MD Ala.), aff'd. 338 F. 2d 337; Swift & Co. v. Morgan & Sturdivant (5th Cir. 1954), 214 F. 2d 115.

with an authorized capital stock of $6,000. Its paid-in capital of $3,000 consisted of 30 shares, of which Henderson owned 18 and a Mr. Anderson and a Mr. Ward owned 6 each. Henderson Mining Company started operations in January, 1960, and elected to file tax returns on a fiscal year basis, with the first period ending May 31, 1960. A timely election to be taxed as a small business corporation within the meaning of Sections 1371 and 1374, Title 26, United States Code (Treasury Regulations on Income Tax, 1954 Code, §1.137-1), was filed by the corporation. During the first five months of operation, the corporation acquired machinery and equipment at a cost in excess of $143,000. It was not disputed that the taxpayer and the other stockholders were aware at the time of incorporation that such equipment would be necessary to carry on the intended corporate business. On January 4, 1960, a special meeting of the directors and officers was held, during which the corporation was authorized to incur an indebtedness not to exceed $150,000, with the indebtedness to be evidenced by notes and the notes to be secured by the assets of the corporation. The stockholders made pro rata advances to the corporation, with Henderson advancing $18,000 on January 5, 1960, $12,000 on February 1, 1960, and $6,000 on February 8, 1961. Anderson and Ward each advanced $6,000, $4,000 and $2,000 on the above respective dates. The $30,000 advanced on January 5, 1960, was used for the purchase of an ore washer; such equipment was essential to the corporation's initial operation. The corporate officials, including Henderson, testified that it was their intention at the time of the initial formation of the business

not to advance the money for the washer and that the money was advanced only because they discovered that a used machine was available. The used washer was purchased from a Mr. Gibson, with whom the taxpayer and Ward had a long acquaintance and with whom Ward was at the time associated as an accountant. There is no question that Ward was familiar with the used equipment owned by Gibson at the time of the incorporation of Henderson Mining Company and knew that certain of Mr. Gibson's ore washers were not in use.

For the alleged purpose of securing these advances, promissory notes, payable upon demand, were executed in favor of these stockholders in the amount of their advances, with the notes bearing 8% interest. No interest was paid by the corporation on these instruments during the fiscal year ending May 31, 1960. However, interest was paid on July 25 and August 3, 1960. At the end of the fiscal year ending May 31, 1960, Henderson Mining Company was also indebted to the taxpayer Henderson in an additional amount in excess of $87,000. Henderson received $1,297 as interest on this indebtedness during the calendar year 1960. On December 12, 1960, a meeting of the Board of Directors was held and the corporation was authorized to borrow $5,000 to make payments to Henderson on his $87,000 loan to the corporation. Payments on this indebtedness were timely as to principal and interest, and the loan was secured by the company's equipment.

During the first fiscal year Henderson Mining Company, Inc., sustained a net operating loss in excess of $22,000,

and Henderson on his personal tax return deducted $133,463 of such loss based on Section 1374, Title 26, United States Code [3]. There is no question that Henderson and the other stockholders were aware of the losses being sustained by the corporation at the time their initial advances came due on July 5, 1960. However, no efforts were made to collect or secure these advances. On July 11, 1960, after the initial $30,000 advance was due, a meeting of the Board of Directors was held, and no discussion concerning payment of either principal or interest, or an extension of said notes, was conducted. In February, 1961, after the notes were long past due, the stockholders advanced the corporation an additional $10,000; this advance was also pro rata in relation to their stock holdings.

Upon consideration of the evidence, this Court now specifically finds and concludes that the taxpayer, Frederick Henderson, and the other shareholders intended to take the risk incident to a capital investment when they made the various advances to the corporation. This question of whether advances to a corporation are, in reality, capital investments or "equity" rather than debt has been considered on

[3] "*§1374. Corporation net operating loss allowed to shareholders*
"(a) *General rule.*—A net operating loss of an electing small business corporation for any taxable year shall be allowed as a deduction from gross income of the shareholders of such corporation in the manner and to the extent set forth in this section.

"(b) *Allowance of deduction.*—Each person who is a shareholder of an electing small business corporation at any time during a taxable year of the corporation in which it has a net operating loss shall be allowed as a deduction from gross income, for his taxable year in which or with which the taxable year of the corporation ends (or for the final taxable year of a shareholder who dies before the end of the corporation's taxable year), an amount equal to his portion of the corporation's net operating loss (as determined under subsection (c))."

numerous occasions by the United States Court of Appeals for the Fifth Circuit. The general rule that has been promulgated by these cases is that the determination of this question depends on an over-all evaluation of the true nature of the relationship created by the advance of money or property. In Montclair, Inc. v. Commissioner, 318 F. 2d 38, the basic criteria to be considered in cases such as this are set forth as follows:

> "The criteria to be considered in determining questions such as this case poses have been thus stated:
>
> 'There are at least eleven separate determining factors generally used by the courts in determining whether amounts advanced to a corporation constitute equity capital or indebtedness. They are (1) the names given to the certificates evidencing the indebtedness; (2) the presence or absence of a maturity date; (3) the source of the payments; (4) the right to enforce the payment of principal and interest; (5) participation in management; (6) a status equal to or inferior to that of regular corporate creditors; (7) the intent of the parties; (8) "thin" or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) payment of interest only out of "dividend" money; (11) the ability of the corporation to obtain loans from outside lending institutions.' O. H. Kruse Grain & Milling Co. v. Commissioner, 9th Cir., 1960, 279 F. 2d 123, 125. See Mertens Federal Income Taxation §26.10c.
>
> "This Circuit has rejected the notion that thin capitalization alone will justify the Commissioner in designating an indebtedness as capital, but recognizes that this factor need not be ignored in determining whether all of the facts authorize the inference of an intent to make a contribution to capital. Rowan v. United States, 5th Cir., 1955, 219 F. 2d 51. Evidence which may tend to prove that a transaction was a contribution to capital may be of many sorts. Sun Properties v. United States,

> 5th Cir., 1955, 220 F. 2d 171; Aqualane Shores, Inc. v. Commissioner, 5th Cir., 1959, 269 F. 2d 116. No comprehensive rule can be stated which will be applicable in all cases. Commissioner v. T. R. Miller Mill Co., 5th Cir., 1939, 102 F. 2d 599."

The United States Court of Appeals for the Sixth Circuit in United States v. Title Guarantee & Trust Co., 133 F. 2d 990, in considering the distinction between a stockholder and a creditor stated:

> *"The essential difference between a stockholder and a creditor is that the stockholder's intention is to embark upon the corporate adventure, taking the risks of loss attendant upon it, so that he may enjoy the chances of profit.* The creditor, on the other hand, does not intend to take such risks so far as they may be avoided but merely to lend his capital to others who do intend to take them." (Emphasis in original.)

In Aqualane Shores, Inc. v. Commissioner, 269 F. 2d 116, and Camp Wolters Enterprises, Inc. v. Commissioner, 230 F. 2d 555, an application of these criteria was made by the United States Court of Appeals for the Fifth Circuit in determining that certain alleged debt instruments were "stock or securities" within the meaning of the applicable statute.

An application of these principles as outlined in Montclair, Inc. v. Commissioner, supra, to the facts in this case requires, as stated above, a finding and conclusion that the advances in question represented a capital investment rather than a debt investment. As a matter of fact, the evidence in this case is even stronger than that in Montclair in demonstrating an intent on the part of Henderson and the other stockholders, to contribute the amounts of the advances

in dispute to the capitalization of the Henderson Mining Company. These amounts as contributed by Henderson and the other stockholders were essential to the inception of the corporate venture and were, accordingly, as above stated, advanced by all of the stockholders, pro rata, in relation to their stock ownership. The fact that no effort was made to secure these amounts is significant in this case. The fact that no effort was made to enforce the instruments evidencing these advances is significant to a determination of the question in this case. The fact that no mention was made concerning the repayment of these amounts in the minutes of the board of directors' meetings, which were held after some of the instruments, purporting to evidence the obligation, were already long overdue. The time of the advances, particularly the initial advance made one month after the formation of Henderson Mining Company, is significant. The use made of the advances, that is, the purchasing of an essential piece of equipment, a used washer, is extremely significant. From all of these factors and others made plain by the evidence but not herein specifically set out, it is clear that at the time of the initial formation of the corporation Henderson Mining Company each of the shareholders was aware that they would purchase the equipment in question and that to do so would require them to advance some $30,000 or more to the Henderson Mining Company. The evidence is clear to this Court that these three shareholders intended to put this additional money in the venture when they formed the business, and there was no intention to enforce the obligations in accordance with their terms.

As to the second pro rata advance, of $20,000, to the corporation on February 1, 1960, this Court likewise specifically finds and concludes from the evidence upon this submission that the taxpayer Henderson, in reality, intended to take the risks incident to a capital investment in Henderson Mining Company. The evidence is quite clear that the money from this advance was used to supply Henderson Mining Company with the essential operating capital; it was known at the time of the incorporation that at least this amount of operating capital was essential. This advance was treated in exactly the same manner as the earlier advance, and the findings and conclusions with respect to this advance are the same as with respect to the first advance discussed in more detail above.

This Court now further finds and concludes that the instruments received by Frederick Henderson from Henderson Mining Company in exchange for his advances to that corporation constituted a second class of stock. Such being the case, the Henderson Mining Company, Inc., did not qualify as a small business corporation and the taxpayer, Frederick Henderson, is not entitled to claim the net operating cost of the corporation on his individual income tax return.

A formal order will be entered in accordance with the foregoing.